ADMINISTRATION'S FISCAL YEAR 1983 BUDGET PROPOSAL

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

SECOND SESSION

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ADMINISTRATION'S FISCAL YEAR 1983 BUDGET PROPOSAL

FRIDAY, MARCH 19, 1982

U.S. Senate,
Senate Finance Committee,
Washington, D.C.

The committee met, pursuant to notice, at 9:06 a.m., in room 2221, Dirksen Senate Office Building, Hon. Robert Dole (chairman) presiding.

Present: Senators Dole, Chafee, Symms, Grassley, and Baucus.

Senator Symms. We resume our hearings on the administration's proposal to raise taxes. And we'll look forward to hearing from the witnesses here today. I see that we have several very distinguished witnesses that will be here. And our first panel is Mr. Paul Huard, Dr. Charls Walker, Mr. Theodore Brophy, and Mr. Richard Lesher. So, gentlemen, could you please come forward. We will be happy to hear from you. I have not had the opportunity yet to read your statements, but from what I've been told about what is in your statements, I think that you will find a great sympathy from the Chair this morning on what you have to say.

We will ask unanimous consent that all witnesses' printed statements will be made part of our record today. And then if those of you wish to speak extemporaneously or if you prefer to give your statement, please do so. We are trying to operate under a 5-minute rule and then have some time for some questions. So if you can try to summarize your statements throughout the morning, we would appreciate it. And this is, incidently, our last day of hearings on the administration's proposal. I indicated to Chairman Dole yesterday that I think it is wonderful that we are having the hearings. I just hope we don't have the markup.

Mr. Huard, would you please go right ahead?

STATEMENT OF PAUL HUARD, VICE PRESIDENT OF TAX AND FISCAL POLICY, NATIONAL ASSOCIATION OF MANUFACTURERS, WASHINGTON, D.C.

Mr. Huard. Thank you, Senator. My name is Paul Huard. I'm vice president of taxation and fiscal policy, Department of the National Association of Manufacturers. NAM represents nearly 12,000 member firms who account for nearly 80 percent of the Nation's industrial output and 85 percent of the Nation's industrial workforce. I am pleased to be here to present the association's views on the administration's tax proposals.

At the outset, we would like to say that NAM strongly supports the President's program for economic recovery. This four-point program announced last year calls for substantial reductions in the growth of Federal spending, major cuts in the taxation of both business and individual, moderation and stability in the growth of the money supply, and regulatory reform to alleviate excessive Government regulation.

We believe this program, if consistently pursued, will provide the climate we need for meaningful improvements in productivity and sustained economic growth. NAM continues to support all four points of this program as a package. We therefore oppose any substantial retrenchment in the tax-reduction component of that program, particularly when that retrenchment would impact so disproportionately on the business sector.

Business liquidity has been depressed by both the decrease in sales resulting from the current recession and the heavy dependence on short-term borrowing at high interest rates to meet working capital requirements. This, in turn, has compounded a longer term trend toward decreased capital formation that was in evidence throughout the late 1970's.

Moreover, while the recovery from the current recession can be expected to begin in the next several months, there is a good chance that it will be somewhat weaker than the average postwar recovery, particularly with regard to durable goods and capital intensive industries.

Given the foregoing, NAM believes it is essential to retain the business cuts enacted in the Economic Recovery Tax Act of 1981. Such retention will increase business cash flow, with the resulting improvement in liquidity leading to greater reliance on retained earnings as a source of working capital. The corresponding decrease in reliance on short-term borrowing will improve debt-equity ratios and ultimately will yield higher capital spending rates.

On the other hand, raising business taxes at this time would entail a serious risk, in our view, of throwing the economy into deeper recession. Tax increases would further reduce business cash flow, forcing companies to increase their reliance on short-term debt at a time when they are already highly leveraged and suffering the effects of high interest rates. If the problem of business illiquidity is so compounded, existing productive capacity will continue to be underutilized, and there will be less new capital investment. Accordingly, the current recession might be prolonged even further, and when it comes, the recovery might be even more sluggish than anticipated.

In short, a major purpose of the Economic Recovery Tax Act—the stimulation of a healthy, prolonged economic recovery—might well be aborted.

Given this backdrop, we are frankly distressed at the apparent haste with which some seem to be willing, in effect, to dismantle the business tax cuts that were so recently enacted. Indeed, there seems to be altogether too little public awareness of the fact that, under the first 5 years of the Economic Recovery Tax Act, only 20 percent of the tax cuts are directed to the business sector. The remaining 80 percent—some $600 billion—goes to individual taxpayers. In light of the business sector's share of the tax cut, we are greatly concerned over the amount of money the administration would withdraw from the business sector, from business cash flow, through its proposed tax changes.

These figures are particularly disturbing when viewed over the next 2 fiscal years, when a healthy recovery from the current recession is crucial. Over fiscal years 1983 and 1984, the administration's tax proposals would amount to 56 percent of the total benefit to be received by the business sector under ERTA over that period. If noncorporate taxpayers—for instance, sole proprietors—are factored out, the fiscal 1983-84 increase in corporate taxation under the administration's tax proposals equals about 75 percent of the corporate tax cuts to be received over that period under the Economic Recovery Tax Act.

Under the circumstances, we cannot help but view these proposals as being adverse to both the specific goal of capital formation and the general goal of economic recovery.

Our testimony goes into some length, but in view of the time requirements this morning I will not go into specific comments on things like the minimum tax and the various other proposals where our positions are outlined.

I will try and summarize our conclusion by saying that the historical tax legislation passed in 1981 was a long overdue step toward reducing the bias in our tax system against savings and investment. NAM, therefore, opposes any general tax increase on either business or individuals at this time. As to the specific so-called tax revisions, we oppose any such proposals which would substantially impair business liquidity and capital formation. In this category we would include proposals to expand the minimum tax, eliminate the completed contract method of accounting, speed up estimated corporate payments, and restrict or repeal the leasing rules.

Further cuts in Federal spending, not increases, are, together with moderation in the growth of the money supply, the key to reducing budget deficits, lowering interest rates, and achieving a healthy economic recovery. In this regard, we believe that no part of the Federal budget, including defense, social security, and entitlement programs should be exempted from the budget cutting process.

Thank you.

Senator SYMMS. Thank you very much for your statement.

[The prepared statement follows:]

STATEMENT
OF
PAUL R. HUARD
ON BEHALF OF
THE NATIONAL ASSOCIATION OF MANUFACTURERS
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
MARCH 19, 1982

My name is Paul R. Huard. I am Vice President of the Taxation and Fiscal Policy Department of the National Association of Manufacturers. NAM represents nearly 12,000 member firms who account for nearly 80% of the nation's industrial output and 85% of the nation's industrial workforce. I am pleased to be here to present the Association's views on the Administration's tax proposals.

Our comments regarding the need for tax increases in order to reduce federal deficits are summarized below:

SUMMARY

- NAM opposes any general tax increase on either business or individuals at this time. The tax component of the President's Program for Economic Recovery is premised upon substantial reductions in the burden of taxation and must be given time to work.

- Further cuts in federal spending - not tax increases - are, together with moderation in the growth of the money supply, the key to reducing budget deficits, lowering interest rates and achieving a healthy economic recovery. No part of the federal budget - including defense, Social Security and entitlement programs - should be exempted from the budget cutting process.
- Tax increases on business should be approached, if at all, only with great caution. The historic tax legislation passed in 1981 was a long overdue step towards reducing the bias in our tax system against savings and investment. NAM therefore opposes any tax revisions which would substantially impair business liquidity and capital formation. In this category we would include proposals to expand the corporate minimum tax, eliminate the completed contract method of accounting and repeal or restrict the "safe harbor" leasing rules.

SUPPORT OF PRESIDENT'S PROGRAM

NAM strongly supports the President's Program for Economic Recovery. This four-point program, as announced last year, calls for:

- substantial reductions in the growth of federal spending
- major cuts in the taxation of both business and individuals

- moderation and stability in the growth of the money supply
- regulatory reform to alleviate excessive government regulation

We believe this program, if consistently pursued, will provide the climate we need for meaningful improvements in productivity and sustained economic growth. NAM continues to support all four points of this program as a package. We therefore oppose any substantial retrenchment in the tax reduction component of that program, particularly when that retrenchment would impact so disproportionately on the business sector.

BUSINESS TAX CUTS SHOULD NOT BE CURTAILED

Overall, we continue to believe that the Administration's Program for Economic Recovery offers excellent prospects for generating higher rates of both capital investment and productivity growth throughout the mid-1980s and beyond. These prospects will be substantially diminished if the Congress enacts major increases in business taxes. Moreover, the current state of the economy, which is now in a fairly serious recession, further underscores the need for retaining the business tax cuts enacted last year. In this regard, there are a number of factors to be considered.

Business liquidity has been depressed by both the decrease in sales resulting from the current recession and the heavy dependence on short term borrowing at high interest rates to meet working capital requirements. This in turn has compounded a longer term trend toward decreased capital formation that was in evidence throughout the late 1970s.

Moreover, while the recovery from the current recession can be expected to begin in the next several months, there is a good chance that it will be somewhat weaker than the average postwar recovery, particularly with regard to durable goods and capital intensive industries.

Given the foregoing, NAM believes it essential to retain the business tax cuts enacted in the Economic Recovery Tax Act of 1981 (ERTA). Such retention will increase business cash flow, with the resulting improvement in liquidity leading to greater reliance on retained earnings as a source of working capital. The corresponding decrease in reliance on short term borrowing will improve debt-equity ratios and ultimately will yield higher capital spending rates.

On the other hand, raising business taxes at this time would entail a serious risk of throwing the economy into deeper recession. Tax increases would further reduce business cash flow, forcing companies to increase their reliance on short term debt at a time when they are already highly leveraged and suffering the effects of high interest rates. If the problem of business illiquidity is so compounded, existing productive capacity will continue to be underutilized and there will be less new capital investment. Accordingly, the current recession might be prolonged even further and, when it comes, the recovery might even be more sluggish than anticipated. In short, a major purpose of ERTA - the stimulation of a healthy, prolonged economic recovery - might well be aborted.

Given this backdrop, we are frankly distressed at the apparent haste with which some seem to be willing, in effect, to dismantle the business tax cuts that were so recently enacted. Indeed, there seems to be altogether too little public awareness of the fact that, under the first five years of ERTA, only 20% of the tax cuts are directed to the business sector. The remaining 80% - some $600 billion - goes to individual taxpayers. In light of the business sector's share of the tax cut, we are greatly concerned over the amount of money the Administration would withdraw from business cash flow through its proposed tax changes.

The figures are particularly disturbing when viewed over the next two fiscal years, when a healthy recovery from the current recession is crucial. Over FY83-84, the Administration's tax increases would amount to 56% of the total benefit to be received by business under ERTA over the same period. If noncorporate taxpayers (e.g., sole proprietors) are factored out, the FY83-84 increase in corporate taxation under the Administration's proposals equals about 73% of ERTA corporate tax cuts over that period. Under the circumstances, we cannot help but view these proposals as being adverse to both the specific goal of capital formation and the general goal of economic recovery.

I will now comment briefly on a number of specific areas of concern.

CORPORATE MINIMUM TAX SHOULD NOT BE EXPANDED

NAM strongly opposes any expansion of the corporate minimum tax. A number of the reasons for our position have already been discussed, e.g., the adverse impact on business liquidity and the dilution of the business sector's ERTA tax cuts. In addition to those general concerns, we fear specifically that the proposed expansion of the corporate minimum tax would impact very adversely on the availability and effectiveness of the investment tax credit (ITC) as a stimulant to investment in new productive plant and equipment. Indeed, under the Administration's proposal, a company with no so-called preferences but which, due to a combination of Accelerated Cost Recovery System (ACRS) deductions and the ITC, has an effective tax rate under 15%, would see part or all of those deductions and credits nullified.

Both in such cases as well as in cases where the minimum tax is triggered due to utilization of preference items (for instance DISC) that were intended to further a specific Congressional goal (e.g., stimulation of exports, in the case of DISC), we think it is both counterproductive and unfair to penalize a taxpayer for acting efficiently in a manner which the Congress saw fit to encourage.

NAM also is concerned that, in addition to posing a significant disincentive to capital investment, the proposed new corporate minimum tax likely would have a disproportionate effect on companies just returning from loss positions to positions of marginal profitability. Finally, we think that by instituting what amounts to a permanent two-track system of computing corporate income tax liability, this proposal would add unnecessary complication to the tax laws.

For all of these reasons, we vigorously oppose any expansion of the corporate minimum tax.

COMPLETED CONTRACT METHOD SHOULD BE RETAINED

NAM believes that the tax laws should continue to recognize that the completed contract method of accounting is the most appropriate method for taxpayers in the construction, shipbuilding and electronics, aerospace and other industries where the contracts involve significant uncertainties regarding profit and loss which are generally not resolved until the completion of the contract. The tax laws should also continue to allow taxpayers utilizing the completed contract method of accounting to deduct, in the year incurred, expenses that historically have been allowed as period costs. Tax policy has long treated advance payments on long term contracts as financing mechanisms and the NAM sees no justification for reversing this long established policy.

The completed contract method responds to problems created by the nature of the long term contractor's business. Unlike a typical manufacturer, a taxpayer using a long term contract method of accounting obtains contracts by bidding or negotiating for specific projects or manufacturing an item that takes more than twelve months to complete. Generally, the original contract price is based on an estimate of the costs to complete the contract. Consequently the contractor may be exposed to risks associated with the reliability of the estimates over the period of time it takes to complete the project. The severity of this risk is determined by many variables outside the control of the contractor, such as strikes, weather, inflation, availability of materials and development of technology. This inherent risk of projecting costs distinguishes the long term contractor from other taxpayers. Sound tax policy therefore requires that taxpayers be permitted to defer revenue and expenses on contracts until they are complete and the income or loss is determined with reasonable certainty.

Moreover, we are concerned that repeal or substantial modification of the completed contract method will have an adverse impact on the United States defense industrial base at a time when the Administration has proposed a substantial increase in defense preparedness. Repeal or substantial modification of the completed contract method as a financing device would require the defense industry to go to the financial markets for large amounts of new capital. Some companies, particularly small and medium sized firms, might not be able to attract the necessary capital and therefore might be forced into bankruptcies or unwise mergers. Those companies able to survive probably would have to borrow funds at high interest rates. This additional cost would raise the defense contractor's overall cost of doing business, which would of necessity increase the cost of weapons systems procurement by the Department of Defense. In effect, therefore, the Treasury's gain would be largely illusory, since it would be offset by the Defense Department's increased procurement costs.

Repeal or substantial modification of the completed contract method of accounting also would have a disastrous impact on the already hard hit construction industry which, like the defense industry, has long utilized this method. Construction contractors need large sums of money to operate and expand. As an industry they are particularly vulnerable to strikes, weather and inflated prices for materials and other factors beyond their control. Retention of funds by developers until the project is complete further complicates the ability of construction contractors to compute their profit with a fair degree of reliability. However, to pay taxes on unfinished projects would limit the size of the project the contractor could bid on and would eliminate a badly-needed source of financing.

Finally, NAM believes that taxpayers utilizing the completed contract method of accounting should be allowed to deduct, in the year incurred, expenses that historically have been allowed as period costs. Period costs are those costs deductible in the year paid or incurred regardless of when income is recognized and are so deducted because they benefit the taxpayer's business as a whole, whereas contract costs or absorbed costs must be deducted at the conclusion of the contract.

Period costs, instead of adding value to the item under contract, represent costs incurred to benefit the operations of the taxpayer as a whole for a particular period or costs that have been made deductible in a certain way to provide an incentive to the taxpayer. On this latter point, for example, it would be particularly inconsistent for the Congress to enact a system allowing the accelerated recovery of capital costs in one year and in the next year to disallow a current deduction for the accelerated portion of the recovery, as would occur under the Administration's proposed treatment of period costs.

Accordingly, it is NAM's position that the accounting methods now applicable to long-term contractors, including the treatment of period costs, should be retained in their present form. Where, however, the Administration believes it has identified a particular area of abuse, for instance with regard to multi-unit contracts spanning a decade or more, we would not oppose appropriate corrective action by Treasury regulation.

SAFE HARBOR LEASING SHOULD BE RETAINED

While the Administration has not proposed to modify or repeal the ERTA rules on safe harbor leasing, the Chairman of this Committee has. Therefore, we believe a brief comment on the leasing rules is appropriate.

NAM fully supports the Administration's view that the safe harbor leasing rules are an integral and necessary part of ACRS. The principal purpose of such rules is to stimulate investment in new plant and equipment by temporarily unprofitable companies. These rules achieve just that by making the cash flow benefits of ACRS and the ITC immediately available to such companies.

By so doing, the leasing rules remove what would otherwise be a substantial disincentive to new investment. These rules also promote tax neutrality by equalizing the costs of investment as between profitable and unprofitable companies.

Also, it should be noted that many leasing transactions now taking place would probably have taken place anyway even under the more restrictive pre-ERTA leasing rules. We think it is highly significant that, under the new safe harbor leasing rules, more of the cash flow benefits of ACRS and the ITC pass to the company utilizing the equipment than would have under the old rules. In other words, the new leasing rules work better and more efficiently than the old rules. We believe they should be retained.

Any action by this Committee on the leasing rules should at least be deferred until the Treasury completes its report on safe harbor leasing based on the information returns filed this January. Thereafter, such abuses, if any, as have been clearly identified can be addressed by appropriate modification. Outright repeal of the safe harbor leasing rules should be rejected.

CONCLUSION

In conclusion, NAM opposes any major increase in business taxation, since such tax increases would impair capital formation and slow the economic recovery. In this regard, we might mention in passing our concern over the Administration's proposal to speed up corporate estimated income tax payments. While not a tax increase as such, the cash flow loss due to the timing difference has the same net effect as a business tax increase and may be particularly inadvisable in this time of general business illiquidity.

NAM strongly urges this Committee to limit any changes in the tax laws to improvements in compliance and enforcement, and the elimination of provisions that are demonstrably duplicative or excessive. Instead of any major increase in the taxation of either business or individuals, we urge the members of this Committee, in their capacity as members of this and other Committees of the Senate, to address the real problem by enacting further major reductions in all areas of government spending.

STATEMENT OF DR. CHARLS E. WALKER, CHAIRMAN OF THE AMERICAN COUNCIL FOR CAPITAL FORMATION, WASHINGTON, D.C.

Senator SYMMS. Dr. Walker.

Dr. WALKER. Mr. Chairman, thank you very much. I am grateful for the opportunity to express the views of the American Council for Capital Formation on the revenue-raising initiatives proposed by the administration and members of the Finance Committee, in particular, proposals for a new minimum tax on corporations.

I will summarize my statement, and read part of it, beginning on page 11. Quite clearly, in the press and in the Congress, a campaign is being mounted to suggest that the business community, in resisting any takeback from the business tax reductions passed last year, is simply being greedy. It is also argued that any scaling back of individual tax reductions without commensurate scalebacks of business tax reductions would be unfair.

If debate on the fairness of individual and business tax reductions is to proceed on a sensible basis, then we must from the first understand a simple fact: Corporations do not pay taxes; people do. It is impossible to tax a business corporation except in a limited first-order sense. This is true of the regular corporate tax, a minimum tax; or any other such levy. A corporation is nothing more than a legal arrangement under which individuals conduct business. And if job creation and growth and living standards over two centuries are any guide, it's a darned good arrangement at that.

When second order effects are considered, it's clear that a business corporation is, in effect, a surrogate tax collector for the Internal Revenue Service. The ultimate payers of the tax are the people who buy the corporation's products, work for it, and primarily as stockholders, provide the capital for the company.

To the extent taxes paid by a corporation are passed forward to consumers, the corporate tax is doubtless regressive. This is because people with low incomes spend higher proportions of their income on the products of corporate America than do people with high incomes, who save more of their income. To the extent that the market for the company's products is weak, as with autos today, the tax must be passed backward to the factors of production. Workers bear a part of the burden through reduced workweeks and loss of jobs. As dividends are cut back, stockholders, many of whom are not well off at all, bear the brunt. This in turn discourages saving, investment, and capital formation. Productivity is damaged and economic growth is hampered.

How much of the corporate tax burden is passed forward and how much backward? Nobody really knows. Some time ago, congressional taxwriting committees made a stab at dealing with the problem by assuming that 40 percent of any corporate tax would be passed through to consumers. This horseback estimate had little basis in logic and, in fact, greatly underestimated the passthrough in strong sellers' markets and overestimated it in strong buyers' markets. The effort was dropped.

Today no estimates are set forth of the ultimate impact on individuals of proposals to collect more taxes from corporations such as the proposed corporate minimum tax. Experts say that the Treasury's new minimum tax would hit 90,000 corporations as contrasted with 5,500 under the existing add-on minimum tax. It is expected that the new minimum tax would most strongly affect steel, mining, electric utilities, industries already in varying degrees of economic trouble, if not distress.

What will be the impact of the new minimum tax on the competitive viability of companies in these industries? On the people who buy from them, work for them, and own them? To what extent will the new minimum tax be passed on as an inflationary, regressive levy on consumers? For electric utilities, probably to a considerable extent; for steel companies, with markets weak and international competition strong, probably only in a small measure. And to the extent the minimum tax on steel companies is borne by stockholders, what is the probable impact on the industry's ambitious plans to spend $7 billion over the next 4 to 5 years for expansion and modernization?

If I were a Member of Congress, these are a few—and only a few—of the questions I would want answered before casting my vote for a stronger minimum corporate tax or, for that matter, any increase in business taxes.

Two other points. I agree with the NAM spokesman who said that under these circumstances, in the midst of a recession, to raise taxes on business is not good policy at all. And to take back what was given last year is surely going to disrupt business planning in the future. Business simply is not going to trust the staying power of the tax incentives for capital formation Congress enacts.

A final point in terms of fairness concerns with the split between business and individual tax cuts in the last several big tax bills. In the Kennedy-Johnson cuts from 1961 to 1965, which included the depreciation, investment tax credit, corporate rate cuts, and the split was 69 percent for individuals, 31 percent for business. The cut President Carter signed in 1978 was split 69 percent individuals, and 31 percent business when fully phased in. In 1980, the Senate voted that if there were any tax cuts coming down the pike it should be split 50-50 between individuals and business because of the severity of the capital formation problem. But what did ERTA do? When fully phased in, ERTA will result in a split of 78 percent for individuals and 22 percent for business. And under the administration's recent proposals, that ratio will move more severely in the other direction. That is not good public policy under these circumstances.

Thank you, Senator.

Senator SYMMS. Thank you very much for an excellent statement.

[The prepared statement follows:]

Statement of Dr. Charls E. Walker
Chairman, American Council for Capital Formation
before the
Senate Committee on Finance

Friday, March 19, 1982

Mr. Chairman and Members of this distinguished Committee:

My name is Charls E. Walker. I am volunteer Chairman of the American Council for Capital Formation. I am grateful for this opportunity to present the views of the American Council on the revenue initiatives proposed by the Administration and Members of the Finance Committee--in particular, proposals for a new minimum tax on corporations.

The American Council for Capital Formation is an association of individuals, businesses, and associations united in their support of legislation to eliminate the tax bias against saving and productive investment. Our members, individuals as well as business, support legislative measures which are designed to encourage the productive capital formation needed to sustain economic growth, reduce inflation, restore productivity gains, and create jobs for an expanding American work force.

We applaud the Finance Committee's intent to review in a timely manner both the tax and spending measures under the Committee's jurisdiction for fiscal year 1983 and beyond in order to fashion a bipartisan consensus on Federal budget, spending and tax policies with the goal of reducing future Federal budget deficits. We urge you to evaluate with utmost care the alternative proposals put forth by the Administration and Members of Congress to reduce spending and raise revenue. While reduction in the large forecasted Federal deficits over the next few years should be a priority of this Congress, great care must be taken to enact measures that do not work against the carefully structured economic recovery program the Administration proposed and Congress, in a praiseworthy bipartisan manner, enacted last year.

With the enactment of the Economic Recovery Tax Act of 1981 (ERTA), we have in place tax incentives that, over time, will lead to strong economic growth and increases in living standards for all Americans. Let us not act in haste and damage, perhaps irrevocably, the promise of the future.

Today, I would like to review the emergence of the consensus on an economic policy for the 1980's. Because the country now faces record-breaking deficits, I would also like to suggest needed short-run adjustments to the economic "game plan" put in place last year.

ECONOMIC POLICY FOR THE 1980'S

The Development of a Consensus

The decade of the 1970's proved to be a time of testing for the economic theories that had dominated policymaking for the past fifty years. In recent years, the economy has been in a long-term decline characterized by "stagflation"--inflation at double digit levels in an economy plagued by stop and go performance, sluggish real growth, and too-high levels of unemployment. The rate of growth in real GNP--which is the most basic measurement of the performance of an economy--had fallen from a rate of 4.3 percent per year from 1959 to 1965, to 4 percent from 1965 to 1969, to 3.6 percent from

1969 to 1973 and to 2.8 percent from 1973 to 1979. Productivity growth, which directly affects the standard of living a society enjoys, had declined sharply over the period.

In addition, the Federal sector had grown rapidly over the decade and was absorbing a high and evergrowing proportion of our nation's economic resources. Total Federal outlays, for example, advanced by 455 percent and nominal GNP by 333 percent from 1965 to 1981. This resulted in a pronounced long-term rise in the ratio of total Federal outlays to GNP. In particular, total Federal outlays rose from 18 percent of GNP in 1965 to 23 percent in 1981. Only twice during the 1970's did Federal spending as a share of GNP fall below 20 percent. On the basis of Administration assumptions and budgeted spending levels, that ratio is now expected to top out at 23.5 percent in the current fiscal year and decline thereafter.

It is clear that the spending programs initiated in the mid-1960's enlarged the share of the nation's resources allocated by the Federal government. Additionally, a shift has occurred in Federal spending priorities over this period, especially from defense to nondefense spending. In 1965, nondefense spending measured 60 percent of budget outlays; by 1981, the nondefense share had risen to nearly 76 percent.

The rapid growth in Federal spending fostered inflation in at least two ways. First, with a firmer monetary policy and even higher interest rates it would have been possible to finance these deficits in a noninflationary manner; that is, by borrowing genuine savings. But, the fact is that too large a portion of the deficit was indirectly monetized by Federal Reserve purchases of government securities in the open market. Monetary growth was excessive and the price level shot up. Second, the transfer payments that made up a substantial portion of the increase in outlays represented a shift in resources from the more productive to the less productive sectors of society. Therefore, capital formation was slower than it would otherwise have been.

As Federal spending rose, taxes went up also, but not by enough to assure balanced budgets. At 21 percent of GNP in FY 1981, Federal tax receipts were at the highest ratio since World War II. This heavy tax burden contributed to stagflation through its impact on incentives to work, save and invest, and the resulting negative impact on productivity.

The heavy tax burden was especially inimical to solid economic growth because of its distribution. Reflecting outmoded economic theories that emerged during the Great Depression, the existing tax system as we entered the 1980's was biased heavily in favor of consumption and against productive saving and investment. For individuals, the high marginal rates that seemed justified to some people in earlier times as good social policy sharply impinged on incentives for individuals to work, save and invest. They also generated the "bracket creep" that seems so unfair to the middle-income Americans who pay the lion's share of individual income taxes. High business taxes depressed capital formation and productivity by reducing the rate of return on new investment and cutting the cash flow available to finance that investment.

Congressional Action

Evidence concerning the capital formation problem began to mount as early as 1973 when Senator Bentsen launched highly constructive capital formation hearings in his Subcommittee on Financial Markets, thus encouraging Congressional debate on the issue. Then, in 1975, the Ways and Means Committee began hearings on what would become the Tax Reform Act of 1976. Tax reform pressures of the traditional "loophole closing" variety crested with that Act, as the public and Congress became increasingly convinced that the developing capital formation problem was not only significant but also could be critical to the nation's long-run well-being.

The Revenue Act of 1978, shaped in crucial ways by this Committee, marked a major shift in economic policy in general and tax policy in particular. At last we began to turn from naive Keynsian policies affecting demand to see fiscal policy as a supply-side tool. The 1978 Act sharply cut the maximum tax on capital gains for individuals, strengthened the investment tax credit, and reduced corporate tax rates, leading the way for the profound changes that would occur over the next few years in tax and economic policymaking. By 1980, it was clear that it was time to change--time to take a hard look at the costs as well as the benefits of government regulations; time to bring Federal spending under control; time to change the tax code to spur saving, personal effort, and risk taking; and time to conduct monetary policy to curb inflation and keep it in check.

In its second consecutive unified annual report, issued in 1980, the Joint Economic Committee, then chaired by Senator Bentsen, signalled the coming of age of this new era in economic thinking. That report recommended that "fully one-half of the next tax cut be directed to enhancing saving and investment in the economy." Noting that traditionally tax cuts had been designed solely as countercycle devices, the JEC went on record in support of the position that tax cuts can and should be directed toward improving productivity performance over the long-run. In addition, the JEC recommended that the ratio of government spending to GNP be reduced.

The Reagan Administration's Game Plan

Coming into office in 1981, the Reagan Administration quickly moved to put in place the supply-side concepts that had been moving into the mainstream of economic thinking. The Administration's 1981 program of budget restraint, approved by Congress, sharply reduced the rate of growth of Federal spending in FY 1982; and further cuts have been proposed in that growth rate in FY 1983 and beyond. The Economic Recovery Tax Act of 1981 reversed the upward trend in taxes relative to GNP and also strengthened incentives to work, save and invest. These steps, along with a retreat from the over-regulation of business activity and strong moral support for a Federal Reserve policy of more stable monetary growth, constituted what the press has called "Reaganomics."

The Current Economic Climate

It is far too early to judge the success of this program. Progress in dealing with Public Enemy No. 1--inflation--has exceeded expectations and, indeed, is the most significant single development of the past year. But, with inflationary expectations deeply imbedded, the return to a non-inflationary environment was bound to take time and involve hardship. That hardship arrived in 1981 in the form of recession, with output dropping sharply and unemployment approaching 9 percent. Interest rates, which Administration policymakers expected to fall as inflation receded, remained stubbornly high, threatening the timing and strength of recovery from the recession.

"Real" interest rates--i.e., market rates less the expected rate of inflation--are at very high levels. According to one school of thought, these high rates--particularly for long-term securities--reflect market fears that, despite their protestations to the contrary, Federal Reserve authorities will sooner or later cave in to political pressure and unduly inflate the money supply to help fight recession and unemployment. Financial market skittishness in this respect is demonstrated by experience over the past two years--each time the rate of monetary expansion has moved above Federal Reserve target ranges, interest rates have tended to go up, but when monetary growth has stayed within bounds, interest rates have come down.

Administration policymakers argue that lower inflation rates must ultimately result in lower interest rates because the inflationary premium which became incorporated into rates in the 1970's will sooner or later be wrung out. They also maintain that the personal saving rate, which has averaged only 5.4 percent of disposable income over the past few years, will rise to at least the 8 to 8½ percent range that prevailed during most of the first half of the 1970's. Following the Kennedy-Johnson tax reductions in the first half of the 1960's--on balance, a very good supply-side tax cut--the personal saving rate rose sharply. The Reagan tax cuts on individuals are concentrated on people who do the most saving, and the new Individual Retirement Accounts constitute a major pro-saving force. With each percentage point representing $20 billion in saving, the potential contribution of an increase in the personal saving rate to noninflationary financing of Federal deficits is obvious.

SHORT-RUN ADJUSTMENT TO THE GAME PLAN

The Deficit Question

Now, however, many voices have been raised to complain that the Federal deficits projected over the next few years are simply too large. It is widely believed, particularly in financial markets, that it is these deficits that are keeping interest rates high and threatening economic recovery. Such deficits, say the critics, will collide with anti-inflationary monetary policies and the only possible result will be high interest rates and "crowding out" of private investment. Moreover, financial markets quite clearly believe that the deficits now in prospect spell trouble, thus impeding the decline in interest rates justified by the improved outlook for inflation.

Deficit financing as a way of life is bad public policy. It removes a practical limit on growth of the Federal sector--growth that got us into this mess in the first place. Chronic deficits also rob financial markets of funds that could otherwise be used to support the capital formation this country so badly needs.

An adjustment to the economic game plan that will sharply cut near-term deficits and return us to a balanced budget relatively soon is, therefore, urgently needed. This correction need not at all disturb the basic framework of Reaganomics that the Administration and Congress put in place last year. It is an adjustment that should be negotiated between the Congress and the Administration, in a spirit of compromise, on a bipartisan basis.

Guidelines for a Compromise

The Administration, in its FY 1983 budget, has proposed a series of tax and spending changes that it estimates will hold the deficit to somewhat above $90 billion in 1983, $80 billion in 1984, and slightly above $70 billion in 1985. However, without corrective action of any kind, the Federal deficit in FY 1983 could well rise to triple-digit levels and remain there for several years to come. Deficits of this magnitude, well in excess of peacetime experience, would impose extreme pressures on financial markets, undermine the outlook for continued monetary restraint, reduced inflation, and economic growth.

Clearly, action is needed to hold spending for on- and off-budget items, at a minimum, to the three quarters of a trillion dollar level the Administration has proposed for FY 1983. As its major contribution to the adjustment in the economic game plan, Congress should act to ensure that total spending levels do not rise above the level requested by the President, or 22.5 percent of the Administration's GNP forecast. For his part, the President should agree to steps that would significantly reduce deficits in 1983 and beyond.

The ACCF strongly favors the spending cut route over the tax increase approach to deficit reduction. The Administration has put before the Congress a number of proposals to reduce spending; Members of Congress have likewise suggested responsible spending cut initiatives. If there are to be tax increases, the Congress should be careful not to undo the critically important capital formation initiatives enacted as a part of the Economic Recovery Tax Act of 1981.

The Revenue Side

The Administration has proposed a number of revenue raising options in its FY 1983 budget. Unfortunately, some of these measures, while perhaps attractive from a revenue standpoint, would actually work against economic recovery and impose an undue tax burden on the business firms least able to withstand further deterioration in cash flow. According to a Congressional Budget Office analysis, a little more than 20 percent of the Administration's deficit reduction proposals for the 1983-1985 period involve revenue increases. However, nearly 75 percent of the revenue increases would come in corporate taxes, offsetting about 60 percent of the corporate tax reduction enacted in ERTA for that period.

The ACCF specifically urges you to oppose substantive modifications to the recently enacted Accelerated Cost Recovery

System (ACRS). The need for a complete and thorough overhaul of our outmoded capital cost recovery system was clearly recognized by the Congress through the enactment of the ACRS provisions of ERTA. The new system will encourage the injection of new investment funds for modernized plant and equipment which are essential to the economic progress and well-being of all Americans.

The largest single revenue raising option proposed by the Administration is a new corporate minimum income tax. The Administration would repeal the current 15 percent corporate add-on minimum tax and replace it with a 15 percent alternative minimum tax. Under the proposal, corporations would pay the alternative minimum tax only when it exceeds the regular income tax. In general, the tax base for the alternative minimum tax would be a corporation's regular taxable income increased by certain tax preferences for the year. Net operating losses would not be allowed in computing the minimum tax base. The tax base would be reduced by a $50,000 exemption.

Debate on the corporate minimum income tax cannot possibly proceed on a sensible basis until all parties understand that it is impossible to tax a business corporation except in a limited "first order" sense; this is true of the regular corporate tax, a minimum tax, or any other such levy. As the present occupant of the Oval Office has said many times, corporations don't pay taxes, people do. A corporation is nothing more than a legal arrangement under which individuals conduct business--and, if job creation and growth in living standards over two centuries are any guide, a darned good arrangement at that.

When "second order" effects are considered, it is clear that a business corporation is, in effect, a surrogate tax collector for the Internal Revenue Service. The ultimate payers of tax are the people who buy the corporation's products, work for it and, primarily as stockholders, provide the capital for the company.

To the extent taxes paid by a corporation are passed forward, to consumers, the corporate tax is doubtless regressive. This is because people with low incomes spend higher proportions of their income on the products of corporate America than do people with high incomes, who save more of their income. To the extent that the market for the company's products is weak, as with autos today, the tax must be passed backward to the factors of production. Workers bear part of the burden, through reduced workweeks and loss of jobs. As dividends are cut back, stockholders, many of whom are not well off at all, bear the brunt. This in turn discourages saving, investment and capital formation. Productivity is damaged and economic growth is hampered.

How much of the corporate tax burden is passed forward and how much backward? Nobody really knows. Some time ago Congressional tax-writing committees made a stab at dealing with the problem by assuming that 40 percent of any corporate tax would be passed through to consumers. This horseback estimate had little basis in logic and in fact greatly underestimated the passthrough in strong sellers' markets and overestimated it in strong buyers' markets. The effort was dropped.

Today no estimates are set forth of the ultimate impact on individuals of proposals to collect more taxes from corporations. Experts say that the Treasury's new minimum income tax would hit 90,000 corporations as contrasted with the 5,500 now affected by the existing minimum tax. It is expected that the new minimum tax would most strongly affect such industries as steel, mining, and electric utilities, industries already in varying degrees of economic trouble, if not distress.

What will be the impact of the new minimum tax on the competitive viability of companies in these industries? On the people who buy from them, work for them, and own them? To what extent will the new minimum tax be passed on as an inflationary, regressive levy on consumers? For electric utilities, probably to a considerable extent; for steel companies, with markets weak and international competition strong, probably only in small measure. And, to the extent the minimum tax on steel companies is borne by stockholders, what is the probable impact on the industry's ambitious plans to spend $7 billion over the next four-to-five years for expansion and modernization?

If I were a member of Congress, these are a few--and only a few--of the questions that I would want answered before casting my vote for a stronger minimum corporate tax or, for that matter, any increase in business taxes. An increase in business taxes would significantly erode many of the capital formation incentives enacted in 1981 and shake business confidence in the staying power of those incentives as well as some enacted in prior law.

Business needs to know it can count on the laws on the books in order to plan for the future with confidence. A firm plans its investment spending programs several years into the future, and thus needs to know with certainty the tax implications of the decisions it makes today.

In addition, we have two specific concerns with the Administration's proposed alternative minimum tax on corporations--the impact on the investment tax credit and on net operating losses (NOLs).

First, recent analysis of the new proposal by Emil Sunley, a former Deputy Assistant Secretary of the Treasury Department for Tax Policy and a member of the ACCF's Policy Committee, has found that the proposed minimum tax, in some cases, would in effect reduce the limitation on the investment tax credit from the 90 percent level enacted by Congress in 1978 to 67.4 percent of regular tax. In other words, the new tax would substantially blunt the incentive effect of the investment credit for corporations--further reducing the willingness and ability of a corporation to invest in needed productive equipment. Dr. Sunley also points out that the major preference items subject to the corporate minimum tax are found in only a few industries. Whether the tax structures of these industries should be altered is a question more correctly addressed separately. In addition, he notes that the tax would have the perverse effect of encouraging tax-induced mergers that serve no useful economic purpose.

It is also the case that even if a corporation has no tax preferences, it may still end up paying the alternative minimum tax under the Administration's proposal. That consequence results because the investment credit cannot be applied in the proposed minimum tax calculation.

Second, the proposed minimum tax would, in some cases, produce results difficult to justify on equity grounds and impossible to justify as policy in the current economic climate.

Rather than being directed solely toward assuring that profitable companies do not, by excessive use of so-called "tax preferences" (credits, special deductions and exclusions from income), escape paying any tax at all, the Administration's proposal imposes a tax where no economic gain exists. As an example, suppose a corporation loses $51,000 in 1982 and, in 1983, has a profit of $51,000 resulting in an economic break-even over the two-year period. The corporation will pay $150 in minimum tax in 1983. Clearly, this makes no economic sense. Even though a portion of the minimum tax paid may eventually be recovered, the impact on a new company starting up, or on one that has undergone temporary difficulties, can be devastating on the company--and is also bad economic policy.

Thus, the proposed alternative minimum tax would work exactly counter to capital formation needs and, indeed, deny some of the benefits enacted in prior years.

Quite frankly, the ACCF and the business community are split on the merits of any tax increase at this time and, if there are to be tax increases, what kind they should be.

I have my personal views which I outlined in testimony presented to the House Ways and Means Committee on February 19, 1982.

The Spending Side

Major attention in the Congress should be focused on Federal spending relative to GNP, rather than on an attempt to achieve a given Federal deficit in any fiscal year. With any year's deficit subject to wide swings as a result of only small changes in interest rates, unemployment, and the rate of economic growth, the deficit as a target is all too often a will o' the wisp.

However, even with these contraints on Federal budget deficit control, there are a number of alternatives on the spending side of the ledger that should be considered.

For example, several highly respected Members of Congress have suggested that the automatic cost of living adjustments (COLAs) could be frozen or reduced to effect substantial short-run budget savings. Much of the rapid growth in entitlement benefits has resulted from the COLAs. In fact, over the last three years, the CPI, which determines most Federal COLAs, has risen faster than wages so that while entitlement-related retirement benefits have maintained their purchasing power, wages of the working population have fallen in real terms. In addition, the CPI contains a flaw in its treatment of housing costs, which results in overestimating price increases during periods of rapidly rising home mortgage interest rates. Consequently, the CPI has risen faster than other price indexes during the last five years.

For the longer run, the ACCF urges Members of this Committee to support enactment of S.J. Res. 58, the Tax Limitation-Balanced Budget Constitutional Amendment which should reach the Floor of the Senate shortly. Cosponsored currently by nine members of this Committee, S.J. Res. 58 would mandate in advance of each fiscal year that Congress adopt a budget statement under which outlays would not exceed receipts. In addition, the annual increase in planned or budgeted receipts would be limited to the rate of growth in national income in the preceding calendar year. As the year progressed, actual receipts would not necessarily equal budgeted receipts; but actual outlays could not exceed budgeted outlays. This would effectively limit the growth in Federal spending to the growth in national income. If a deficit were needed in case of national emergency, Congress could plan a deficit by having the vote of three-fifths of the membership in each House.

The Amendment would allow a deficit to occur in a recession if actual revenues fell short of planned budget receipts. Alternatively, if the economy needed cooling off, Congress could plan for tax receipts to exceed the rate of growth in national income by a vote of a majority of the whole membership in each House and the approval of the President.

The timing proposed by the Amendment would fit nicely with the intent of Congress to restore a balanced Federal budget by 1985 or 1986. Under the timetable proposed by the Amendment, it would become effective in FY 1986.

CONCLUSION

President Reagan is correct in his determination to stick with the fundamental thrust of his economic game plan put in place last year. Unfortunately, we are faced with record high Federal deficits and must reduce them. Our focus should be on spending cuts, not tax increases. If there are to be tax increases, they should be carefully crafted to avoid undercutting the capital formation aspects of ERTA. The proposed new alternative minimum tax on corporations would do just that and, therefore, should not be enacted.

If financial market participants were convinced that these steps were taken to control short- and long-term deficits in earnest--and this would require a strong bipartisan consensus in the Congress--interest rates would decline sharply. The prospect for short-term economic recovery would be greatly strengthened, and the door opened for the increased business investment spending that is the key to restoration of long-term economic expansion.

STATEMENT OF THEODORE F. BROPHY, COCHAIRMAN, BUSINESS ROUNDTABLE, AND CHAIRMAN, GTE, WASHINGTON, D.C.

Senator SYMMS. Mr. Brophy.

Mr. BROPHY. Mr. Chairman, distinguished members of the committee, my name is Theodore F. Brophy. I am chairman and chief executive officer of General Telephone & Electronics Corp., cochairman of the Business Roundtable and chairman of its taxation task force.

I appreciate the opportunity of appearing before you today on behalf of the Business Roundtable, and presenting its views on the administration's budget proposals, and specifically, the tax proposals.

The administration's economic recovery program was developed as a response to deep-seated structural problems in our economy. It built up over a long period of time. The Roundtable has strongly supported the basic principles and objectives of this economic program, and continues to believe that the program's direction is sound and should be pursued.

At this time, through a combination of circumstances, we are faced with a recession, inordinately high interest rates, and a prospect of continuing substantial budget deficits. Neither a monetary nor fiscal policy can assume full responsibility for solving these problems. It's clear that a steady, predictable monetary policy is necessary to calm volatile financial markets. At the same time, there is a strong and general perception that the large projected budget deficit creates the possibility of continued high interest rates. Unless dealt with promptly—and I underline promptly—that expectation will delay reasonable recovery from the current economic recession, and may exacerbate the situation.

For this reason, the Roundtable is deeply concerned about the size of the projected budget deficits. The need for action is clear and urgent. A stalemate on the budget with its adverse implications for interest rates, financial markets, employment, and the general economy is not an acceptable alternative. This committee and the Congress, working on a bipartisan basis with the President, must seize the opportunity to change the direction of projected deficits and put them squarely and decisively on a downward path without altering the basic thrust of our current economic strategy.

It has been suggested that large budget deficits do not have an adverse impact on interest rates. While this may have been true during most of the postwar period, the evidence since 1979 no longer appears to support this concept. Large projected deficits have caused many in the business community to believe that at some point in the future the Fed will be forced to cave in and monetize a significant portion of the debt. This belief is keeping inflationary expectations alive and contributing to higher interest rates. If we can now adjust our fiscal policy framework so that it will show a lower projected deficit, the Fed will be able to stay with the anti-inflationary policy without being excessively restrictive. This would permit a long-term decline in interest rates.

The seriousness of the deficit situation requires that budget projections include more substantial spending cuts. It is not realistic to assume that this can be achieved without scrutinizing every agency, department, and area of the Federal Government, including entitlements and defense. The deficit problem cannot be adequately addressed without a permanent modification of the method of indexing the entitlement programs to reduce their growth.

We recognize that there is a bipartisan commission currently studying social security, and believe that that important effort should be continued. However, the existence of that commission should not delay a prompt resolution of the indexing issue.

We fully support a strong defense posture, believing that it is critical to our national security and to the stability of the world. A strong economy in future years is also helpful in protecting our Nation. We believe that defense spending should be reexamined on its merits, and directly in relation to its contribution to military capability and the Soviet threat—to insure that these spending levels are essential. If this is done, we believe it will be possible to generate additional savings through improved planning and efficiency without impairing national security.

To the extent that revenue increases are required, we would prefer to see them in the consumption areas. In this area, the proposals that seemed to hold the most promise are increases in Federal excise taxes and users' fees, and deregulation of natural gas. Increasing the level of excise taxes could raise substantial revenue and would have the least disruptive impact on incentives to work, save and invest in the future planning of individuals and businesses. The timing would seem ideal for gas deregulation because it would serve as a revenue producer and come at a time when energy costs are declining.

As a final option, and only if required to meet critical economic needs, we would recommend a stretchout of the 10 percent July 1983 individual cut.

It should be emphasized that we are opposed to any modification of the July 1982 cut. Under present circumstances, we believe that individuals will benefit more from the stimulation of the economy that would result from lower deficits and interest rates than they would lose from a short delay or minor modification in the implementation of the 1983 cut.

We don't recommend any other changes in ERTA with the exception of tightening the safe harbor leasing rule to eliminate any possible abuses.

The administration has proposed tax revisions including a minimum tax. These proposals would reduce business benefits from ERTA by about 40 percent for fiscal years 1983 through 1985. The business community certainly doesn't object to the Government improvement in its tax-collection procedures. However, strong opposition exists in the business community to the administration's proposed alternate minimum tax which is widely viewed as an ill-advised attempt at substantive tax reform. This tax would fall unevenly across industry, penalizing those who are most capital intensive. And would, in some cases, result in greater tax burdens than existed before ERTA. If this committee believes that there are provisions in the tax law that should be modified, reexamined, or eliminated, they should be dealt with directly rather than indirectly through a minimum tax.

In summary, the Business Roundtable urges that a bipartisan plan be implemented promptly. And that that plan address the critical need of producing lower future deficits on a credible basis and insure sound economic recovery and long-term growth.

Thank you.

Senator SYMMS. Thank you very much.

[The prepared statement follows:]

STATEMENT OF THEODORE BROPHY, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, GENERAL TELEPHONE & ELECTRONICS CORP.

Mr. Chairman, distinguished members of the Committee. My name is Theodore F. Brophy. I am chairman and Chief Executive Officer of General Telephone & Electronics Corporation. I serve as Co-Chairman of The Business Roundtable and Chairman of its Taxation Task Force. The Roundtable is an organization comprised of approximately two hundred chief executive officers from corporations that represent many billions of dollars of capital investment and provide millions of jobs for our nation's economy. I sincerely appreciate the opportunity to appear before you today on behalf of The Business Roundtable and to present the Roundtable's views concerning the Administration's budget proposals in general, with specific reference devoted to the tax aspects of such proposals.

During his first year in office, President Reagan introduced an Economic Recovery Program designed to achieve the long-range goal of a vigorous, competitive economy with essential price stability by adopting a strategy of reducing the growth of government spending, the heavy tax burden and repressive regulation and encouraging a sound, consistent monetary policy. With the cooperation of Congress, major parts of this program, representing a dramatic shift in our national economic strategy, were enacted into law, laying a solid base for economic recovery and growth. We have seen real progress, to date, in the form of a lower rate of inflation. The Roundtable supported the basic principles and objectives of this economic program and continues to believe that its direction is sound and should be pursued.

The Administration's economic strategy was developed as a response to deep-seated, structural problems in our economy. These problems became embedded over a long period of time and will, no doubt, take substantial time and effort to cure. The Administration has set the proper long-range course for economic recovery, and as it moves forward, economic conditions may dictate that adjustments be made to the plan in order to keep it on course.

We are currently faced with difficult economic times. Through a combination of circumstances, a severe recession is in progress and at the same time, we are experiencing inordinately high interest rates. Budget projections, a detailed analysis of which is attached as Exhibit I, have been released that hold out the prospect of continuing large deficits and substantial future government borrowings to fund such deficits. As Exhibit II indicates, most private economic forecasters are projecting even higher deficit figures than the Administration. At the same time, there is a growing perception in the business community that large projected budget deficits for Fiscal Years 1983, 1984 and 1985 create the possibility of continued high interest rates. That expectation will delay reasonable recovery from the current economic recession, and unless dealt with promptly, will serve to exacerbate the current situation. Low economic growth increases government expenditures and decreases revenues, thereby widening budget deficits. For these reasons, The Business Roundtable is deeply concerned about the size of projected budget deficits and believes that a "mid-course correction," but not a change in policy direction, must be made in our current economic strategy to reduce these deficits.

The need for action is clear and urgent. A stalemate on the budget, and its implications for interest rates, financial markets and the general economy, is not an acceptable alternative. We must seize this opportunity to change the direction of projected deficits and put them clearly on a substantial and progressively downward path. At the same time, we should not reverse the basic thrust of our current economic strategy. This result cannot be achieved without the guidance and support of both political parties in Congress. Statesmanship must be exercised on a bipartisan basis.

The Effect of Budget Deficits on Interest Rates

It has been suggested that large budget deficits do not have an adverse impact on interest rates. While this may have been true during most of the postwar period, the evidence since 1979 no longer appears to support this concept. A historical comparison of budget deficits and interest rates is shown in Exhibit III.

The chart was developed using "real" short-term interest rates, i.e., nominal rates adjusted for inflation, and by seasonally adjusting the surplus/deficit figures. When the data is presented in this way, a parallel pattern can be seen. But this pattern does not imply a direct cause and effect relationship.

At the onset of the recession, interest rates usually peak as businesses and households attempt to maintain their spending plans in the face of declining revenues. Then as the recession becomes more broadly established and economic activity declines, budget deficits rise and interest rates generally decline due to a slackening in loan demand. In the latter stages of recovery, interest rates again rise as loan demand increases and inflation accelerates.

The key point is that this pattern changed significantly after 1979. As can be seen in the chart, after 1979, the pattern shows a divergence with sharply higher real interest rates and a substantially larger deficit. While there is no single factor that clearly explains the rise in real interest rates, it is generally agreed among businessmen and economists that this may be due to increased uncertainty regarding the future course of monetary policy, especially in view of the projected large budget deficits. Since 1979, the Federal Reserve has refused to monetize the deficit, and has placed new emphasis on controlling the money supply in an effort to reduce inflation. This change can be seen in the table in Exhibit IV. The table clearly shows that the degree to which the federal debt has been monetized has been greatly reduced since 1979. The large projected deficits have caused the financial markets to believe that this refusal to monetize will be only a temporary phenomenon and that at some point in the future the Fed will be forced to cave in and again monetize significant portions of the debt. This belief is keeping inflationary expectations alive and is contributing to higher interest rates.

The change in the Federal Reserve's policy was one of the important factors behind the recent improvement in inflation (Exhibit V). We have no choice but to provide a fiscal policy framework that will enable the Federal Reserve to stay with its anti-inflationary policy without being excessively restrictive. This would permit a lasting decline in interest rates.

Another change since 1979 is in the magnitude of the deficits. The current and projected deficits, as shown in Exhibit VI, are much larger, in absolute magnitude and relative to GNP, than during most of the postwar period. Moreover, for most of the period, the deficits were becoming larger only during periods of recession or mini-recession, whereas most current projections indicate that, unless significant action is taken, the deficit will be increasing at a time when the economy is expected to be in a recovery.

In order to finance large deficits during a period of recovery, the Treasury must either increase its borrowing from the public at a time when private demand for funds is also increasing, or the Federal Reserve must monetize a portion of the deficit, leading to a rekindling of inflationary expectations. Thus, rising deficits during a recovery will contribute to higher interest rates either because of an increased demand for funds or because of renewed inflationary expectations.

While it is true that a significant increase in personal savings rates could provide adequate funds to satisfy both private and public financing needs and still permit interest rates to drop substantially, the problem is that we are dealing with an equation that has many uncertainties. One of these uncertainties is the future rate of savings. If the savings rate in the future is high enough to accommodate these large projected budget deficits as well as growing private financing needs during an economic recovery, then the deficits would not have an adverse effect on the level of interest rates. There is always the possibility, however, that savings may not be adequate to finance both needed capital formation and growing deficits at the same time, in which case the large deficits will result in high interest rates or high inflation or both. Given the unknowns involved we cannot do our planning on a best case approach.

In addressing these economic policies it is not possible to focus only on the tax and spending sides of this equation, so let me say a brief word about monetary policy.

Monetary Policy

A sound, consistent monetary policy is necessary for the success of the President's program. A plausible plan to reduce budget deficits in future years would relieve some of the pressure on the Federal Reserve. It would permit the Federal Reserve to pursue its policy of moderating the growth of money supply without causing undue increases in interest rates.

Large budget deficits threaten to undermine the Federal Reserve's antiinflationary policy. This was clearly pointed out by the Council of Economic Advisers in the 1982 Economic Report of the President:

> Theoretically, restrictive monetary policy could achieve price-level stability regardless of fiscal policy. As a practical matter, however, reducing

> the growth of government spending and reducing deficits in the Federal budget will help to strengthen the belief that anti-inflationary policies will be maintained. That, in turn, will help lower the costs of adjusting to lower rates of inflation. In short, the credibility of monetary policy is influenced by the fiscal policy that accompanies it.

In other words, large deficits make it difficult for the Federal Reserve to implement a credible anti-inflationary monetary policy. More importantly, prospects of persistent deficits, especially during a period of expected economic recovery, leads the financial community to expect that at some point in the future the Federal Reserve will be forced to monetize a portion of the debt. Thus, it is not only actual monetization of government debt, but also the increased likelihood of monetization in the future that promotes inflationary expectations. This fear that the Federal Reserve may be forced to monetize a portion of the deficit in the future may be one of the reasons why interest rates have remained so high even during the present recession. The United States has the highest level of "real" interest rates among industrial countries (Exhibit

VII). Moreover, real interest rates are likely to remain high if investors believe that deficits of the current magnitude will persist for a long time. High real interest rates discourage capital investment and may be at least partially responsible for the current severe slump in the economy.

The Federal Reserve can also enhance its own credibility by achieving a more stable and gradual deceleration in money supply growth, which it was not able to achieve in 1981. As can be seen in Exhibit VIII, money supply growth continues to be highly erratic. It was well below the Federal Reserve's targets during most of last year, but ended the year with a rapid surge. Many analysts have advanced the argument that by being overly restrictive during much of 1981, the Federal Reserve inadvertently contributed to the current recession. As the recession deepened in the fall of 1981, the Federal Reserve permitted a surge in the money supply which was very evident in the early part of January, 1982. More recently, the money supply has again declined. By eliminating these gyrations -- either above or below the targets -- the Federal Reserve can reassure the financial markets, reduce the volatility of interest rates, and thus assist in promoting a more stable and sustained economic recovery.

The Need for Additional Spending Reductions

To the extent that the budget deficits can be closed through reductions on the expenditure side, this would be preferable for the long-term health of the economy. In this regard, no area of budget expenditures should be free from scrutiny, including defense and entitlements. We are not advocating a reduction in outlays for these programs, just slower rates of growth.

In particular, we cannot postpone any longer the difficult decision to bring the growth of entitlement programs under control and place them on a sound financial basis. Entitlements represent 47% of budgeted expenditures for 1983. They have been increasing in cost at a rate of about 15% a year -- far in excess of the general rate of growth of the economy. It is a matter of simple arithmetic that this condition cannot endure forever.

One of the major factors driving up expenditures for many of these programs is that they are 100% adjusted to the Consumer Price Index (CPI) by a process called "indexing." This is the case for social security and military and civil service pensions. We believe that the CPI, as currently constituted, frequently overstates the rate of inflation as it affects the consumer. For this reason, we support a thorough reexamination of indexing -- including the formula to be used, and the timing of forthcoming adjustments -- as a major part of an overall program to put our retirement systems and other entitlement programs on a sound financial basis. Slowing the rate of growth of these programs by changing the method of indexing and by delaying or freezing benefit levels for a time is critical to a credible attack on the deficits. This approach would not have an adverse effect on need or means-tested programs.

We recognize that there is a bipartisan commission currently studying social security and we certainly believe that this important effort should continue and will be of great benefit to the future health of the system. The commission will be reporting its findings and recommendations later this year. The indexing issue has already received widespread study, and it is critical that it be addressed immediately. The existence of the commission and its expectant report should not delay important decisions which should be made this spring.

We also recognize that some entitlement programs are considered to be untouchable in an election year. However, we were encouraged by recent reports in the New York Times that some groups representing the elderly, such as the American Association of Retired Persons and the American Legion, are so concerned about projected budget deficits that they may be prepared to accept some adjustments to these programs. This, we feel, is directly comparable to what is happening in many industries as workers are agreeing to deferrals of wage increases and COLA increases in order to keep their jobs in being.

We fully support a strong sustained defense posture, believing that it is critical for our national security and for the stability of the world. A strong economy in future years will also be helpful to the protection of our nation. Defense spending represents more than 25% of projected expenditures. We believe that defense spending should be reexamined--on its merits, and directly in relation to its contribution to military capability and the Soviet threat--to reaffirm that it is all essential and will be put in place at minimum cost. If this is done, we believe it will be possible to generate additional savings through improved planning and efficiency, without impairing national security.

Revenue Increases

Assuming substantial spending reductions can be achieved, we recognize that additional revenues may still be needed to close the projected deficit gaps to reasonable levels. Our federal income tax system has, for many years, been directed toward increasing consumption and has acted as a disincentive to capital formation, personal savings and productive efforts. We supported action taken last year by this Congress and the Administration to change the direction of federal tax policy as essential for the long-term health of our economy. The Economic Recovery Tax Act of 1981 ("ERTA") has provided important tax relief for individuals and business, and if given a chance to succeed, will stimulate savings and investment. In the process, it will increase productivity, create more jobs and expand our tax base. To the extent that additional revenue increases are required, we would prefer to see them in the consumption area.

In the consumption area the proposals that seem to be the most sensible are increases in federal excise taxes and user fees. Increasing the level of federal excise taxes could raise substantial revenue and would have the least disruptive impact on incentives to work, save and invest and future planning for individuals and businesses.

The timing would seem ideal for gas deregulation beginning in 1983 because it would serve as a revenue producer and come at a time when energy costs are declining. In the long-run, this may hold energy costs down and decrease our reliance on foreign energy sources. Gas deregulation would stimulate exploration efforts and promote conservation.

As a final option, and only if it is required to meet the critical economic need for a steady and significant reduction in projected deficits, we would recommend a stretchout of the 10% July, 1983 individual tax cut. It should be emphasized that we are opposed to any modification of the 10% July, 1982 tax cut. We are also not recommending an elimination of the 10% July, 1983 cut, but, only as a last resort, a stretchout of its implementation in order to reduce the deficit to acceptable levels and to permit a lower and more reasonable level of interest rates. Under present circumstances, we believe that individuals will benefit more from the stimulation of the economy that would result from lower interest rates than they would lose from a short delay or minor modification in the implementation of the 1983 cut.

We strongly believe that ERTA provided important incentives for increased capital formation that are essential for future economic growth. Changes in the tax law, however, cannot, by themselves, dictate investment decisions. A capital spending boom could not have been expected in the face of the current high levels of interest rates and the slowdown in our economy. Investment decisions are a function of profit opportunities, market forces and interest rates, as well as taxes. We would oppose changes to any other provisions of ERTA, with the exception of tightening of the safe harbor leasing rules to eliminate any potential for abuse.

The Administration has proposed tax revisions and improved collection and enforcement procedures that would raise about $12 billion in Fiscal Year 1983 and $35 billion in the succeeding two fiscal years. Most of these measures would apply to business and would reduce business' benefit from ERTA by about 40% for Fiscal Years 1983-85. The business community does not object to the government's improvement of its tax collection procedures. There is, however, strong opposition in the business community to the Administration's proposed alternative minimum tax on corporations.

It should be noted for the record that business received a substantially smaller portion of the total tax reduction provided by ERTA than it received in other major tax reduction acts, such as the Revenue Acts of 1962, 1964 and 1978. We do not say this by way of complaint, because we supported ERTA, but we say this for the record because now is not the time to kill the goose that lays the golden eggs in the form of more jobs.

The proposal for an alternative minimum tax on corporations is widely viewed in the business community as an ill-advised attempt at substantive tax reform that is seriously flawed from both an economic and tax policy standpoint. Among the Roundtable's specific reasons for opposing this measure we would include the folowing:

- The minimum tax will constrain corporate cash flow at a precarious time in our financial history.
    - The New York Times reported on March 12, 1982 that current corporate liquidity is at its lowest point since World War II.

- Its impact will fall unevenly throughout industries and taxpayers.
    - One company may have basically the same tax picture as a competitor in the same industry, except for the fact that it is engaged in a large capital expansion program, and as a result, is subject to the minimum tax while

its competitor is not. The impact of the tax could be particularly onerous for a company trying to recover from a period of economic distress by accelerating its growth.

- It is more sensible from a tax policy standpoint to adjust perceived abuses in the tax law directly rather than indirectly through a minimum tax.
  - If a particular provision is a problem or has outlived its usefulness, the minimum tax is an ineffective and incorrect way to cure the ailment.

- The minimum tax could neutralize many of the benefits of ERTA.
  - Many companies in the steel industry estimate that they will have higher future federal tax bills as a result of the minimum tax than they would have experienced if ERTA had not been enacted.

- The minimum tax reduces the value of the investment tax credit, and in effect, penalizes capital formation.
  - A recent survey indicated that more than 50% of the electric utilities would be adversely affected by the minimum tax constricting the utilization of their investment tax credits, particularly those with active expansion programs (creating jobs, etc.).

- The minimum tax could lead to large future business tax increases.
  - Any item on the widely-disputed "tax expenditure" list could become a candidate for inclusion on the list of tax preferences.

- The minimum tax will add tremendous complexity to the tax laws and a new degree of uncertainty to business planning.

The tragedy of the minimum tax is that recent financial statements, adjusted for inflation under the mandate of FASB Statement No. 33, indicate that many U.S. corporations have little or no real economic earnings, a problem which was partially addressed by ERTA.

In Conclusion

Clearly this is a time for a bipartisan effort of Congress and the President, working together, to produce a budget plan which will show to the American people that the federal government has control over its financial resources. The economy cannot accept a stalemate in the budget process. Time is of the essence; failure to act will delay the recovery and most likely increase the projected deficits.

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Exhibit I

ADMINISTRATION PROJECTIONS OF BUDGET DEFICIT

1. Budget Deficit Estimates - Fiscal Years; Dollar Amount in Billions

	1982	1983	1984	1985	1986	1987
Administration forecast	-98.6	-91.5	-82.9	-71.9	-66.0	-53.2
Alternative deficit projections						
Higher growth/lower inflation	-94.0	-74.7	-50.7	-23.9	-0.6	28.8
Lower growth/higher inflation	-102.8	-108.3	-115.1	-119.9	-131.4	-135.2

2. Economic Assumptions - Calendar Years; Percent Change:

	1982	1983	1984	1985	1986	1987
Real GNP growth rate:						
Administration forecast	3.0	5.2	4.9	4.6	4.3	4.3
Higher growth scenario	4.2	6.4	6.1	5.8	5.5	5.5
Lower growth scenario	1.8	4.0	3.7	3.4	3.1	3.1
Inflation (GNP deflator):						
Administration forecast	7.2	5.5	4.9	4.6	4.6	4.4
Higher growth scenario	6.0	4.3	3.7	3.4	3.4	3.2
Lower growth scenario	8.4	7.7	6.1	5.8	5.8	5.6
Unemployment rate:						
Administration forecast	8.9	7.9	7.1	6.4	5.8	5.3
Higher growth scenario	8.6	7.1	5.7	4.5	3.3	2.3
Lower growth scenario	9.2	8.7	8.5	8.3	8.3	8.3

3. Total Deficit, Including Off-Budget Deficit - Fiscal Years; Dollar Amount in Billions

	1982	1983	1984	1985	1986	1987
Receipts	626.8	666.1	723.0	796.6	861.0	925.7
Outlays	725.3	757.6	805.9	868.5	927.0	978.9
Budget Deficit	-98.6	-91.5	-82.9	-71.9	-66.0	-53.2
Off-budget deficit	-19.7	-15.7	-14.3	-11.0	-10.9	-9.3
Total deficit	-118.3	-107.2	-97.2	-82.8	-77.0	-62.5
Range	-113.7 to -122.5	-90.4 to -124.0	-65.0 to -129.4	-34.9 to -130.9	-11.5 to -142.9	+19.5 to -144.7

4. Deficit Reduction Program
Assumed in the Above Estimates - Fiscal Years; - Dollar Amount in Billions

55.9	84.1	93.3	NA	NA	NA

Source: Budget of the U.S. Government for FY 83, February 1982.

Exhibit II

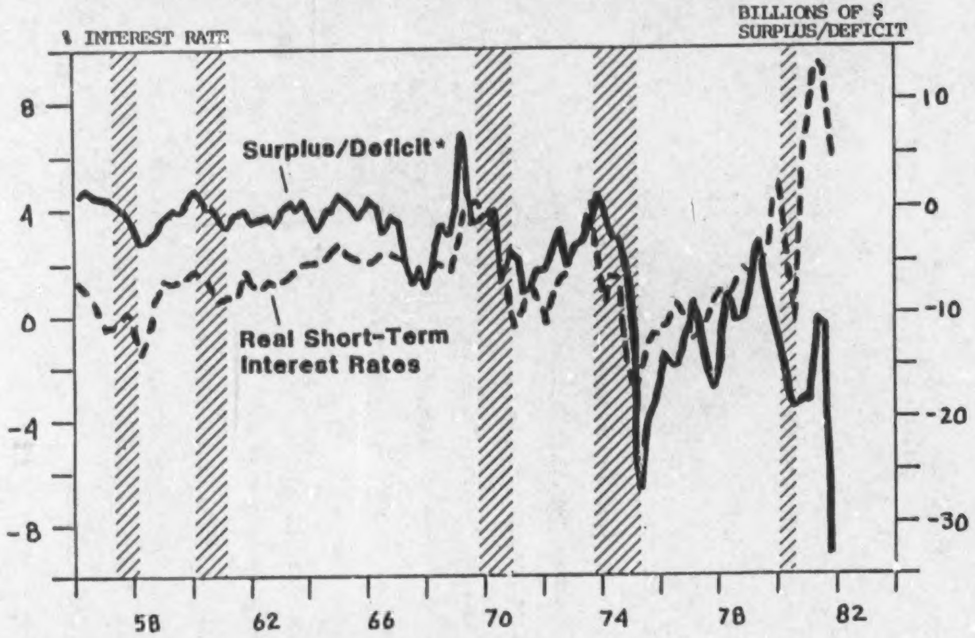
COMPARISON OF BUDGET DEFICIT PROJECTIONS

(Dollar Amount in Billions)

	Fiscal Years		
	1982 $	1983 $	1984 $
• Administration Forecast:	98.6	91.5	82.9
• Private Forecasts:			
Lawrence Chimerine (Chase Econometrics)	108	110-130	80-100
Michael K. Evans (Evans Economics)	109	125	116
Kathleen Cooper (Security Pacific)	95-100	100-110	NA
James Frailick (Morgan Guaranty)	105-115	120-140	140-160
Alan Greenspan (Townsend-Greenspan)	98	120	118-135
David Jones (Aubrey G. Lanston)	95-100	120	130
Irwin Kellner (Manufacturers Hanover)	105	95	90
Alan Lerner (Bankers Trust)	95	110-120	130-150
Don Maude (Merrill Lynch)	95-100	130-140	140-150
Allen Sinai (Data Resources)	107.2	108.7	103.6
Gary Shilling (Shilling and Co.)	95-105	100-120	90-110
Robert Sinche (Bear Stearns)	100-105	145-150	150
John Wilson (Bank of America)	100-120	90-100	NA
• Range of Private Forecasts	95-120	90-150	80-162
• Congressional Budget Office	111.0	120.6	128.9

Exhibit III

FEDERAL GOVERNMENT SURPLUS OR DEFICIT VS. REAL SHORT-TERM INTEREST RATES



* Unified Budget Basis, Seasonally Adjusted

Exhibit IV

RECENT TRENDS IN DEBT MONETIZATION
(Dollar Amount in Billions)

Fiscal Year $	Unified Budget Deficit $	New Federal Borrowing From Public $	Federal Debt Purchased by Federal Reserve $	Percentage of New Federal Borrowing Monetized %
1970	-2.9	5.1	3.6	70.6
1971	-23.0	19.2	7.8	40.8
1972	-23.4	18.5	5.8	31.4
1973	-14.9	19.2	3.7	19.3
1974	-4.7	3.0	5.5	183.3
1975	-45.2	50.8	4.3	8.5
1976	-66.4	82.9	9.7	11.7
1977	-57.9	71.9	10.3	14.3
1978	-48.8	58.8	10.1	17.2
1979*	-27.7	33.6	0.7*	2.1*
1980	-59.6	70.5	5.3	7.5
1981	-57.9	79.3	3.6	4.5

Source: Harris Bank

Comment: * Since October 1979, the Federal Reserve is committed to control the growth of money supply. This means that the Fed will no longer monetize federal debt to stimulate a recovery, as it had done in past cycles.

Exhibit V

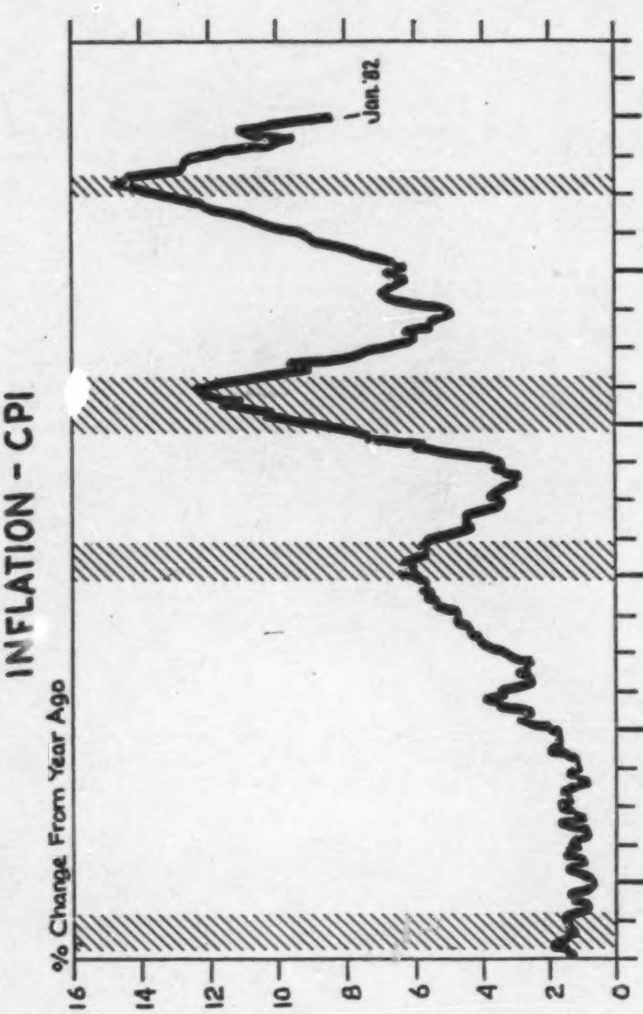

INFLATION - CPI
% Change From Year Ago
16
14
12
10
8
6
4
2
0
62
66
70
74
78
82
Jan '82

Exhibit VI

TOTAL FEDERAL BUDGET SURPLUS OR DEFICIT*
AS A % OF GROSS NATIONAL PRODUCT

(Dollar Amounts in Billions)

Fiscal Year	Amount $	As percent of GNP %
1958	-2.9	-0.7
1959	-12.9	-2.7
1960	.3	.1
1961	-3.4	-.7
1962	-7.1	-1.3
1963	-4.8	-.8
1964	-5.9	-1.0
1965	-1.6	-.2
1966	-3.8	-.5
1967	-8.7	-1.1
1968	-25.2	-3.0
1969	3.2	.4
1970	-2.8	-.3
1971	-23.0	-2.2
1972	-23.4	-2.1
1973	-14.9	-1.2
1974	-6.1	-.4
1975	-53.2	-3.6
1976	-73.7	-4.5
1977	-53.6	-2.9
1978	-59.2	-2.8
1979	-40.2	-1.7
1980	-73.8	-2.9
1981	-78.9	-2.8
1982**	-118.3	-3.8
1983**	-107.2	-3.1

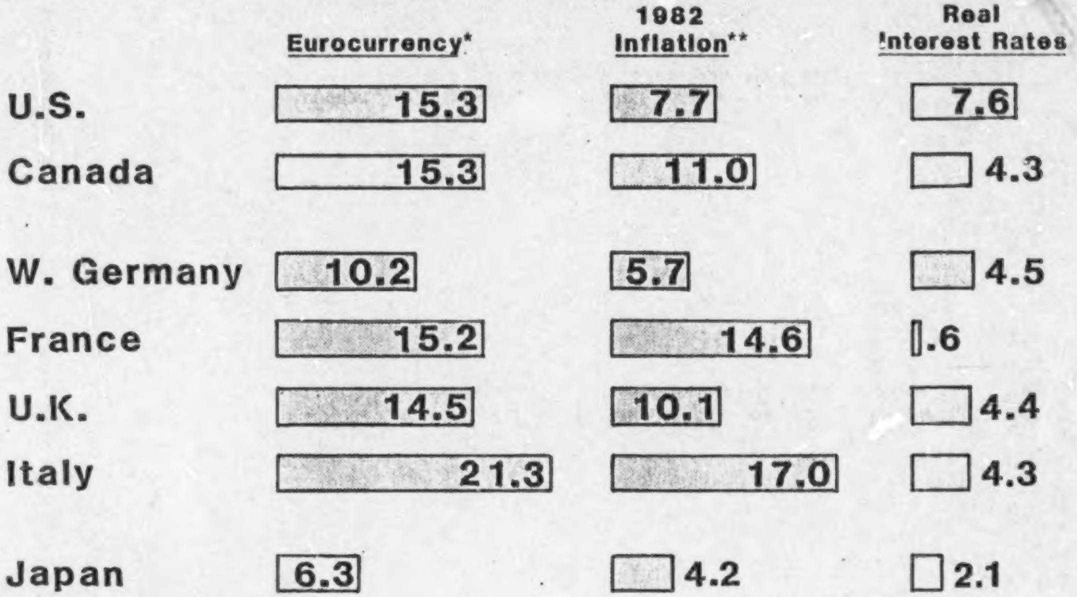
* Total Federal Budget Surplus or Deficits = Federal Unified Budget Deficits or Surplus Plus Off-Budget Deficits

** Administration Estimates

Source: Budget of the U.S. Government for Fiscal Year 1983, February 1982.

Exhibit VII

HIGH REAL INTEREST RATES



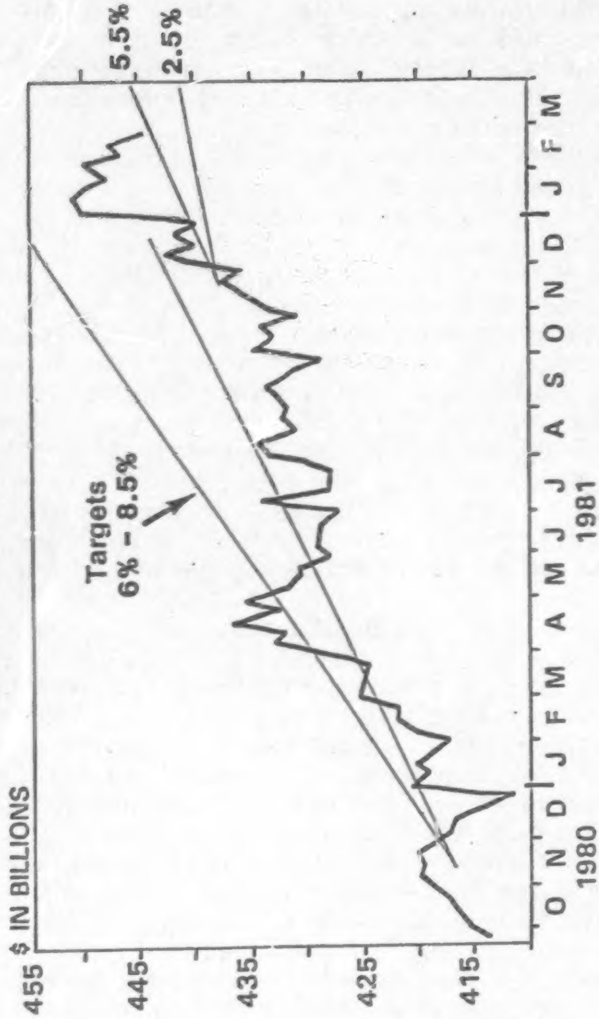
* February 19, 1982 Three-Month Eurocurrency Rates

** Annual Average Percent Change in CPI from GTE January 29, 1982 Weathervane

Exhibit VIII

MONEY SUPPLY GROWTH BELOW TARGETS DURING MOST OF 1981

(Weekly Averages of M1)



STATEMENT OF RICHARD LESHER, PRESIDENT, U.S. CHAMBER OF COMMERCE, WASHINGTON, D.C.

Senator **Symms**. Mr. Lesher.

Mr. **Lesher**. Mr. Chairman and gentlemen of the committee, I am Dick Lesher, president of the Chamber of Commerce of the United States. And on behalf of our more than 225,000 member companies and 5,000 local chambers and trade associations, we are pleased to have this opportunity to testify before this distinguished committee on the matter of taxes.

I will take a few moments just to summarize the statement that we have submitted for the record.

Gentlemen, I realize that the issues before this committee are complex, but sometimes we can get so fancy with fine tuning that we lose sight of the basic issue here. Very simply, a major tax increase now would be economic suicide. No one has shown me any evidence that such an increase would significantly reduce the deficit or that interest rates would miraculously take a nosedive on the day that that bill is passed. But there is plenty of evidence, including the lessons of history, to indicate that a tax increase would stifle economic recovery, and actually reduce the revenues available to the Government. Even the good Lord Keynes, who still has more disciples around this town than we care to recognize, said, "Given sufficient time to gather the fruits, a reduction of taxation will run a better chance of balancing the budget than a tax increase."

Have we given President Reagan's tax programs sufficient time to bear fruit? Just ask the American worker. In 1981, he received a tax cut of exactly 1.25 percent, actually in real terms, much less than that. And now he is told by some that Congress cut his taxes too much last year. This is nonsense. The American people need and deserve the full 25-percent reduction in tax rates that Congress promised them last year. They deserve it because it's their money to begin with, a fact that Washington wise often forget. They need it simply to stay ahead of inflation, bracket creep, and the rising social security taxes. And surely our Nation needs this program, including the tax incentives passed for business, if we ever hope to resume our position of world economic leadership.

Mr. Chairman, I know I have been blunt. But in recent days I've seen a host of media reports claiming that the business community is jumping ship as fast as it can from the Reagan economic program. Let me set the record straight—as you have already been hearing this morning. The U.S. Chamber of Commerce, which is the Nation's largest and most broadly based business federation, has not backed off one bit. Our members, like all Americans, are worried about the effects of high budget deficits, but we and the majority of the general public are convinced that the only successful formula for reducing them is economic growth, and cuts in Federal spending. We remain committed to the President's four-point program of tax cuts, reduction in the growth of Federal spending, regulatory relief, and steady moderate monetary growth. The need for this positive economic program is even more compelling today than it was a year ago. I'm confident that growth will be ours if we can convince you to leave the tax cuts alone. We can finally have real spending control, too, once Congress summons the political courage to make some very tough decisions.

On behalf of the U.S. Chamber, we stand ready to give whatever guidance and support you need to accomplish this task.

Thank you very much.

[The prepared statement follows:]

STATEMENT
on
TAX PROPOSALS
before the
SENATE FINANCE COMMITTEE
for the
CHAMBER OF COMMERCE OF THE UNITED STATES
by
Richard L. Lesher
March 19, 1982

I am Richard L. Lesher, President of the Chamber of Commerce of the United States. On behalf of our more than 225,000 businesses, chambers and associations, I welcome this opportunity to testify on tax proposals. I am accompanied by Richard L. Breault, Vice President, Program and Federation Development, David E. Franasiak, Director of the Tax Policy Center and Dr. Ronald D. Utt, Associate Chief Economist for Economic Policy.

SUMMARY

The Chamber remains firmly committed to the Administration's four-point economic recovery program of tax cuts, reduction in the growth of federal spending, regulatory relief, and steady, moderate monetary growth. In particular, we continue to support the principles of the Economic Recovery Tax Act of 1981 and recommend against enactment of any major tax increases. A tax increase is a grave error. It would stunt economic recovery and fail to solve the deficit problem.

We share the concern that many members of this Committee and others have expressed regarding the large deficits forecast for 1983 and beyond. These deficits can and should be reduced. But the proper way to reduce these deficits is through spending cuts, not tax increases.

With federal outlays now at an all-time high of nearly 24 percent of GNP, Congress can unquestionably make significant reductions in spending. We generally support the Administration's spending reduction proposals. Additionally, we suggest:

- Further reductions in entitlements and other non-defense spending,
- A smaller defense increase, and
- A one-year freeze on all cost of living adjustments (COLA).

The freeze on COLAs alone would save $24 billion. Together, these savings would be large enough to shrink the deficit meaningfully.

CUT SPENDING; DO NOT INCREASE TAXES

The public is concerned about the deficits. In response, some members of the Administration, the Congress and even private sector have begun to advocate tax increases. We agree that the deficit is a problem. However, enactment of a major tax increase would be a grave mistake which would jeopardize the well-being of our citizenry. The Economic Recovery Tax Act of 1981 (ERTA) is the cornerstone of a comprehensive set of policies to revitalize the economy and ensure stable growth in the standard of living. Over the past several years the Chamber has encouraged policies to enhance productivity growth, boost savings and investment, and improve our competitiveness in world markets. Last year, the President proposed, and Congress enacted, a series of bold tax cuts to achieve these goals.

The need for a positive economic program is even more pressing today than it was a year ago, and the problem is now compounded by a recession that spread faster and further than anyone anticipated a few months ago.

Under these circumstances, it is counterproductive to enact tax increases or delay the already enacted tax cuts. Tax increases reduce consumer spending power and businesses' ability to invest, thus slowing private economic activity and raising unemployment. As Appendix 1 shows, tax increases of the size sought by the Administration will cost the economy significant and growing amounts of income, employment and sales. Greater tax increases would have proportionally more damaging effects. The Committee should note that the imminent recovery predicted by virtually all forecasters depends on the tax cuts becoming effective as legislated.

Concern for deficits, while clearly justified, can be misguided when not related to the primary objective of the Program for Economic Recovery -- reducing the share of national income that accrues to government. This share has reached record levels. Lowering it should be the major goal of public policymakers. Debate over the source of this share -- taxes or borrowing -- distracts from our primary objective of reducing government spending and may even preclude our ever attaining it.

The deficit is a symptom of deeper problems. The current deficit is a result of excessive federal spending over the past twenty years. The Congress has failed to come to grips with entitlement programs that continue to grow at rates in excess of the Nation's ability to finance both them and other urgent national objectives. In effect, a tax increase this year would be an acknowledgement of our failure to control spending.

We at the Chamber find this attitude to be dangerously premature. A large deficit provides a reluctant Congress with a powerful incentive to cut spending growth. Raising taxes diminishes this incentive and reduces the sense of fiscal urgency required to make the tough choices on budget priorities.

Expressed this way, the appropriate policy response to our deficit problem is to seek further cuts in federal spending, with no area of the budget exempt from consideration. In part, the current budgetary dilemma stems from decisions made by the Administration, with Congress' concurrence, to exclude defense and Social Security spending from the budget reduction exercise. While such a decision may have been appropriate last year, such an exclusion is undesirable while the Nation is confronting what amounts to a fiscal emergency.

History of Tax Rate Changes

The history of tax rate changes in this country and abroad makes this point forcefully. To cite just a few examples: Rate reductions in the U. S. in the 1920s, 1946, 1948, 1964-65, and 1978 (for capital gains) all led to dramatic growth in revenues. Conversely, rate increases in 1916-20, 1932, and 1968-69 were quickly followed by sharp drops in reported income, tax collections, and economic activity. Rate reductions in Germany in 1948, Japan in 1950, and Puerto Rico in 1977-79 were followed by steep upturns in economic growth and tax receipts.

The most egregious instance, which is somewhat similar to today's circumstances, occurred in 1932. Then, as today, the economy was in a slump and the deficit was growing. The Hoover Administration and Congress agreed to raise taxes by $900 million, or nearly 30 percent of the 1931 level. However, receipts actually fell by $1.2 billion in 1932, the deficit widened from $0.5 billion to $2.7 billion, and the depression worsened.

Business Uncertainty

Constant modification of the tax code leads to greater business uncertainty and hampers corporate investment. Stability in the tax system is essential to the goal of stimulating the economy through business expansion. However, businesses cannot make investment decisions when tax policy changes from day to day. ERTA was aimed at stimulating capital investment by providing for accelerated depreciation, larger investment tax credits, and safe-harbor leasing. When proposals are made to repeal a major portion of these tax incentives within six months after the enactment of that bill, businesses will not make a decision to invest that may be at all dependent on these incentives.

Public Opposes Tax Increases

The public opposes tax increases. In the latest U.S. Chamber-Gallup Consumer Opinion Survey, conducted in December, only 4 percent favored tax increases alone, and only 21 percent favored a combination of tax increases and spending cuts to lower the deficit. More than twice as many respondents preferred reducing spending alone. That poll also showed better than 2-1 support for more spending cuts, and strong opposition to a variety of consumer tax increases. (See Appendix 2 for full text of questions and responses.) Other recent polls find the same attitudes prevail.

In sum, a tax increase now will be unpopular and will retard economic growth. It may not narrow the deficit appreciably, and even if it does, such a result is irrelevant to lowering interest rates or improving economic well being. There is no good rationale for a tax increase.

Individual Income Tax

Among the most frequently suggested tax increases here on Capitol Hill is the delay of the individual rate cuts. A large portion of the U.S. Chamber's 225,000 members consists of unincorporated businesses that report their business incomes as individual taxpayers. The three-year individual rate cuts are the backbone of the individual relief under ERTA. As enacted, they are already scaled back in time and amount from the President's original proposal for 10 percent cuts in 1981, 1982, and 1983. The enacted cuts are barely sufficient to keep most taxpayers whole, even given the recent lessening of inflation. Any delay would allow personal and business tax burdens to rise above their record high levels and would seriously undermine ERTA's incentives for individual work, saving and investment.

Corporate Tax

The media has projected the perception on Capitol Hill and around the country that corporations no longer pay any income taxes. In response to this perception, legislators have proposed the repeal of safe-harbor leasing and the adoption of an alternative minimum tax.

The corporate income tax is not dead. The 1983 Budget figures show that after a one-year drop in receipts from $61 billion in fiscal 1981 to $47 billion this year (due as much to the recession as to ERTA), corporate tax receipts are projected to climb rapidly to $65 billion in 1983, $84 billion in 1984, and $88 billion in 1985. In fact, between 1982 and 1984, the corporate share of total receipts would grow from 7.5 to 11.6 percent, while every other revenue source remains virtually steady or declines as a share of total receipts. To quote Samuel Clemens: "The reports of my death are greatly exaggerated."

In considering corporate tax changes, Congress should also bear in mind that corporate taxes are actually paid by individuals--consumers, employees, shareholders, pensioners. The corporation acts only as tax collector for the government. If the corporate income tax is increased, companies will pass on the burden to customers by raising prices; to workers by laying off staff, shortening hours, or reducing wage and benefit increases; and to shareholders by realizing lower profits. Retirees can lose in all three capacities, facing higher consumer prices, smaller pension fund contributions by the companies, and slower growth in dividends and stock prices whether owned directly or through their pension fund. The relative effect varies from one firm to another, but in all cases it is individuals who suffer, not companies.

Safe-Harbor Leasing

Safe-harbor leasing is an important part of the Accelerated Cost Recovery System (ACRS) enacted in ERTA. It spreads the benefits by allowing economically sound companies with temporary losses to utilize ACRS fully, and in this way facilitates increased investment in new plant and equipment. If the Congress believes that there are abuses in the use of these provisions, it should be certain to define the abuses correctly and modify the safe-harbor leasing rules accordingly. Leasing is designed to stimulate the economy by encouraging capital investment and should not be repealed solely because of "bad public perceptions".

Moreover, the Chamber supports the expansion of the safe harbor leasing provisions to allow closely held businesses to participate as lessors without the application of the "at-risk" rules contained in Section 465 of the Internal Revenue Code. Under the present rules, small businesses in which 50 percent or more of the value of the outstanding stock is owned directly or indirectly by not more than five individuals are effectively denied the opportunity to participate as lessors.

Safe-harbor leasing helps assure that the entire economy will be stimulated without encouraging unsound investments made strictly as tax shelters, and it substantially reduces the complexity and uncertainty under the old leasing rules. For these reasons, we oppose repeal of the leasing provisions and support changes to allow full participation by the small businesses.

Minimum Tax

There is no adequate rationale for enacting the alternative corporate minimum tax. It is not responsive to criticisms that corporations pay no taxes, and it does little to close the budget deficit while causing great distortions in investment activity.

The Treasury's proposal undermines ACRS. Under the proposal, the investment tax credit could not be used to reduce the minimum tax due. Accelerated depreciation and larger investment tax credits were enacted to encourage capital investment. Disallowing the application of the investment tax credit to the corporate minimum tax would greatly weaken the investment incentive which last summer Congress agreed was so desperately needed to stimulate economic recovery. That need is still present today. In circumstances where a company would be subject to the minimum tax for a period of years, the benefit conferred by the investment tax credit may in certain cases be reduced from 90% to as little as 67% of regular tax liability.

Another problem with the minimum tax proposal is that net operating loss carryovers may not be considered in computing the alternative minimum tax base. The impact of the tax can be particularly onerous for firms or industries recovering from a period of economic distress and firms attempting to accelerate growth with heavy investments in research or capital assets.

The minimum tax would also cause great complexity in business planning. Under the alternative minimum tax, corporations which have tax deductions resulting from a variety of different operations covered by the tax preference items would be subject to the minimum tax. Other corporations which have even more deductions to offset income may not be subject to the minimum tax if these deductions are not in the tax preference areas. Thus, the capricious selection of certain corporate tax deductions as tax preference items results in discrimination between taxpayers.

We strongly oppose any substantive changes in the treatment of the foreign tax credit as it relates to the corporate minimum tax. The credit operates to prevent double taxation of foreign earnings. A denial of credit for taxes previously paid abroad would be inequitable to those corporations with foreign operations. Without such credits, operating costs are increased and competitiveness is lowered.

Accelerated Corporate Tax Payment

The proposal to increase federal revenues by an acceleration of corporate payments would increase tax burdens for thousands of companies while providing only a one-shot benefit to the Treasury. Although the proposal would require companies to make estimated payments of only 90% of the tax due, many firms say they would in effect be forced to overpay their taxes to be sure of avoiding the penalty for underpayment. An increase in the penalty provisions for underpayment of taxes exacerbates this problem. ERTA changed the interest rate penalty from 12% to the prime rate in effect the prior September, which means the rate is now 20%. The speed-up particularly impacts firms in cyclical industries and others with fluctuating income because these companies cannot rely on prior year's earnings to estimate current liability accurately.

Dividend and Interest Withholding

We oppose the Administration's plan to require five percent withholding on dividends and interest. This plan would result in heavy compliance costs for hard-pressed financial institutions and other payors, and in over-withholding from many law-abiding taxpayers, while failing to effectively stop tax evasion. There are other steps Congress and the IRS should examine short of imposing these costly and unjust burdens.

IRS Personnel Increase

The Chamber supports the proposal to add 5,225 more staff members to the Internal Revenue Service, provided the additional personnel are used to maximize compliance and reduce tax evasion rather than to add to the burdens of the overwhelming majority of taxpayers who are law-abiding. The IRS has been given tasks of steadily increasing complexity, without the added personnel to match. Meanwhile, the perception of spreading tax evasion has grown. These new personnel, wisely used, can increase both compliance and public confidence in the tax system. Higher collections from existing law reduce the impetus to impose burdensome new taxes.

Conclusion

We continue to support President Reagan's four-point economic recovery program because it offers a complete formula for long-term economic growth. The deficit problem must be addressed by slowing the growth in government programs, not through increased taxes. Higher taxes do not guarantee a balanced budget, only slower economic growth, less employment, and chronic stagflation. An increase in taxes at this time will only relieve the pressure for further budget cuts and hamper the economic recovery. We urge Congress to allow the economic recovery program, which you overwhelmingly supported less than a year ago, to work. Do not take back the individual and business tax cuts before they can operate to rejuvenate our economy.

APPENDIX 1

Economic Effects of Tax Increases, 1983-86

	1983	1984	1985	1986
GNP (billions of $)	- 3.7	-15.3	-37.2	-68.2
After-tax corporate profits (billions of $)	-13.3	-20.6	-23.7	-28.9
Employment (millions)	0.0	- 0.1	- 0.3	- 0.5
New car sales (millions)	0.0	- 0.2	- 0.4	- 0.7

Source: U.S. Chamber of Commerce, Forecast Center.
Assumes tax increases as listed in the 1983 Budget: $12.7 billion in fiscal 1983, $19.0 billion in fiscal 1984, $18.2 billion in fiscal 1985, and $17.7 billion in fiscal 1986.

APPENDIX 2

Consumer Attitudes Toward Spending Cuts and Tax Increases

In January, additional reductions in government spending may be proposed in order to reduce the size of the federal government deficit and move closer to a balanced budget. Would you strongly favor, somewhat favor, somewhat oppose, or strongly oppose making additional reductions in federal government spending?

Strongly favor	Somewhat favor	Somewhat oppose	Strongly oppose	Don't know
31%	28%	14%	12%	15%

If you had to choose, which of the following would you prefer to do in order to reduce the size of the federal deficit: reduce federal government spending, increase federal taxes, or would you prefer to both reduce federal spending and increase federal taxes?

Reduce federal spending	Increase federal taxes	Both reduce spending and increase taxes	Neither (Volunteered)	Don't know
54%	4%	21%	8%	13%

Last summer, income tax rates were cut by 25 percent, and scheduled to go into effect in three stages as shown on this card. Recently, some people have proposed that the tax cuts scheduled for July 1982 and July 1983 both be postponed six months in order to reduce the deficit in the federal budget. Other people have proposed that these two tax cuts both be put into effect six months earlier, or postponing them by six months, or letting them go into effect in July 1982 and July 1983 as scheduled?

Start six months earlier	Postpone six months	Start as scheduled	No tax cut (volunteered)	Don't know
30%	21%	29%	3%	17%

Another proposal is to eliminate the federal income tax deduction for interest paid on consumer loans, except that interest paid on a loan to buy an automobile would still be deductible. Would you favor or oppose eliminating the federal income tax deduction for interest on consumer loans, except for interest on automobile loans?

Favor elimination	Oppose elimination	Don't know
28%	52%	20%

Source: U.S. Chamber-Gallup Consumer Opinion Survey

The survey involved 1,480 face-to-face interviews by The Gallup Organization with a representative sample of the U.S. public, 18 years and older conducted between December 11-14, 1981. It is very probable (95 chances out of 100) that the survey findings are within three percentage points of the figures that would have been obtained if the entire adult population had been interviewed.

Senator **Symms**. Thank you all for very excellent statements. Senator Baucus, any questions?

Senator **Baucus**. No.

Senator **Symms**. Senator Grassley.

Senator **Grassley**. I think you, Dr. Lesher, have laid it out very clearly and shown there is some difference between the solution your organization proposes for solving economic problems as opposed to other business organizations. From my standpoint as a basic supporter of the President's program as well as for my ideas for reducing the deficit this year, I want to compliment you on your stand. To make it clear for the record, do you support whatever measures need to be taken to reduce the deficit on the expenditure side as opposed to the revenue side?

Mr. **Lesher**. That's correct.

Senator **Grassley**. In other words, you aren't suggesting any change in tax laws passed last year at all?

Mr. **Lesher**. That's correct.

Senator **Grassley**. And you aren't suggesting raising any other sort of revenue from excise taxes?

Mr. **Lesher**. That is correct.

Senator **Grassley**. You aren't suggesting undoing the third year of the tax cut as has been suggested by some?

Mr. **Lesher**. We think that that would be a very grave error. We think one of the beauties of last year's tax package, which was given leadership by this committee, was the stability implied in a 3-year program. If we tinker with tax policy on a day-to-day or week-to-week or month-to-month basis, we will continue to see instability in policy and instability in financial markets. We believe that the tax reductions of last year should be kept, plus those that don't come into play until later this year and next year. We believe that the job has not even been started on the other side of the ledger, and it's time to focus attention, exclusively, on that side of the ledger so that we can get spending reductions and the growth of Government under control.

Senator **Grassley**. I know you stated broad support for the President's program. I've offered an alternative to what the President suggested with Congressman Denny Smith from the State of Oregon. Our program would freeze 1983 expenditures at 1982 levels to quickly ratify last year's budget decisions to make an impact on the business and financial community. I would like to know your comments on our approach—is it to great a departure from the President's program to merit any consideration? You see some adjustments in entitlements and COLA's beyond what the President has suggested? It is reasonable to change the level of defense expenditures below what the President suggested? Would your support of the President's program preclude your looking and considering alternatives like Congressman Smith and I have suggested?

Mr. **Lesher**. We would encourage everyone to take a positive look at the Smith-Grassley bill, including the tax side of that bill. We believe retention of the tax reductions that were passed last year are very much in order as we have already stated. And we believe that there are some technical difficulties with the freeze on the spending side, but it is a proposal which does focus attention in the right direction. And, therefore, it is to be commended.

We, specifically, would go further in proposed reductions than have been submitted by the administration. And we would be pleased to submit to this committee, as we have done in the past, a detailed list of the amounts that could be reduced from other programs, including the Defense Department.

Senator GRASSLEY. Do you see any problems with the concept of a freeze as opposed to the budget adjustments proposed by the President?

Mr. LESHER. I think the concept is fine. I think there are some technical difficulties, increased enrollments, in certain parts of programs. And if you have an absolute freeze, you would have to make that up somewhere else. Programs of that kind, and multiyear contracts are problems that can be dealt with. I am so weary of hearing the suggestions that so much of the Federal budget is fixed in concrete, and uncontrollable. I suggest that every last nickel in the Federal budget, in the longer sweep of things, is, indeed, controllable. And the responsibility for that control rests in the two Houses of the Congress.

Senator GRASSLEY. What's your prognosis on the economy in the near term or let's say in the next 6 months?

Mr. LESHER. We have a fairly optimistic outlook for the economy. We believe that the worst of the recession is behind us. We believe that we are going to see economic growth through the balance of this year. In fact, the news this morning suggests that some of that growth is beginning to take place. We believe that unemployment will decline, that inflation will stay down, that interest rates will begin a decline which will continue not only through the balance of this year, but through most of next year. On balance, we think the recession is—the worst is behind us. And this is going to be a growth year.

Senator SYMMS. Thank you very much.

Senator Grassley, in your Grassley-Smith plan, when would you achieve a balanced budget? What's projected?

Senator GRASSLEY. According to CBO figures which I think represent a middle ground between certain other projections, the budget would be balanced by late 1984 or 1985.

Senator SYMMS. And that's a freeze on all across the board?

Senator GRASSLEY. Yes, all budget functions would be frozen including COLA's and entitlements. This would be a significant reduction in what the President proposes to spend in those areas. There would be some increase in discretionary categories, but there would be much less spending in defense.

Senator SYMMS. One area of taxes that I have said that might be worth considering—and I have been surprised that the Treasury hasn't brought it up or the administration because Secretary Lewis has been talking about the necessity. And I think that most Americans, particularly in the northern part of the United States when they start driving their automobiles here and see the break up of the roads, they are probably going to be concerned about the quality of the transportation system in this country, or the highway system. How do you feel about raising the Federal fuel users' fee and users' fee in general for increasing our ability to maintain the highway system? I would just like to ask the question of each one of you. I mean money that would be dedicated into the trust fund for transportation uses.

Mr. **Lesher**. Basically, we support the concept of user fees. But the way the proposal is generated at the present time, it's an excise tax on fuel. And we believe that the excise taxes on gasoline are already too high. And we would oppose additional increase in taxes for a whole host of reasons, not the least of which is that you don't normally increase taxes during a recession period.

Senator **Symms**. Dr. Walker.

Dr. **Walker**. In general, I subscribe to the view that you do not raise taxes during a recession, but I want to look a little beyond that. I assume, as Dr. Lesher does that there will be a recovery. It will probably be somewhat on the anemic side. But, looking ahead and speaking for myself, I think there is a strong case in favor of some tax increases in the energy area. The deregulation of natural gas, accompanied by an across-the-board severence tax, an oil import fee, or perhaps a gasoline tax could certainly be justified. If Congress wanted to dedicate some of the revenues raised to highways, perhaps this could be done.

Senator **Symms**. How's the impact on the commerce of the country going to be if we let our highway system decline?

Dr. **Walker**. I share your concern on that, sir, and I am not arguing against it. I suggested that increased taxes in the energy area and some dedication of the revenues to maintain the highway system has considerable merit.

Senator **Symms**. Mr. Huard.

Mr. **Huard**. Well, Senator, I have several comments on that. One, if in fact, the funds from an increased tax were to be dedicated to improving the highway network, that would be consistent with our general view in the user fee area, for instance, that people who are getting the service ought to be willing to pay a fair price for it. And I think to that extent we would be inclined to be sympathetic with it.

If viewed as an excise tax, I'm inclined to agree with Dr. Lesher and Dr. Walker that this is probably not the time to increase any taxes. I will state, however, that we are more inclinced to be sympathetic to a tax on consumption rather than a tax on income, savings or capital because of the fact, as we stated previously, we think that if we are going to have a prolonged and sustained recovery, we have to keep the gains we made last year in the 1981 act in reversing the bias against savings and investment.

Senator **Symms**. Mr. Brophy.

Mr. **Brophy**. Yes. We would favor increased user fees or excise taxes. We've suggested that even after we've made all the budget cuts that can be made, and we reemphasize that the burden of reducing the deficit has to fall on cutting spending, that even beyond that so that we are not operating on a best case set of assumptions, which I believe the budget was built on, assumptions that even today have seen deterioration, that there will be some need for additional revenues. And we would favor those revenues in the first instance to come from excise taxes and consumption taxes. Particularly, with the reduction in the cost of fuel, a tax on gas, an excise tax on gasoline, would appear to be one feasibility.

Senator SYMMS. Well, didn't you advocate, though, slipping the 1983——

Mr. BROPHY. We did that also as a last resort. Yes.

Senator SYMMS. When you look at the social security system and see that since 1970 that the payments have been increased 205 percent and you look at the wage rates in the country where weekly earnings have only been increased 121 percent before tax dollars, wouldn't that be very inequitable not to address the COLA's first before we talk about that?

Mr. BROPHY. We surely agree with you. We believe that indexing on entitlement programs has to be the first area that has to be addressed in order to get deficits under control. The entitlement programs have been growing at a rate in excess of 15 percent a year. We've had a situation where the benefits that have been delivered have exceeded inflation by almost any reasonable measure. We have anomalous situations that have been created where retired Federal employees are receiving larger pensions than the incumbents are receiving in salaries. I was very pleased last Wednesday to read in the New York Times that the American Association of Retired People had indicated that they would willingly accept or at least accept a cut in the growth of entitlements if that would cut the deficit. So I think there is a changing perception in the American people. They are concerned about the deficits, and are willing to step up and accept those small sacrifices that are necessary.

Senator SYMMS. Mr. Lesher.

Mr. LESHER. Mr. Chairman, if I could just add a comment there. The total amount that could be saved on the spending side of the ledger is on the order of $24 billion just in terms of a freeze on COLA's. And that should be considered against the backdrop or the fact that——

Senator SYMMS. Say that number again.

Mr. LESHER. $24 billion out of this year's budget considerations could be saved by freezing all COLA's in the Federal expenditure programs. And that should be considered against the backdrop of the fact that in the private sector, less than 5 percent of salaries and far less than 5 percent of pensions are indexed in any way at all. So I think there is a general feeling by the general public, a question of why we could be so generous in the public sector without demonstrating the need as compared to what is taking place in the private sector.

Senator SYMMS. I absolutely agree. I think anything less than freezing COLA's right now is absolutely irresponsible on the part of the Congress. And we have to do it. And we just have to go out and explain it to people. And I think they will accept it.

I want to ask you another question on the interest rate question. What would you do differently than Paul Volcker if you were chairman of the Federal Reserve Board?

Mr. LESHER. You are talking to me?

Senator SYMMS. Yes. [Laughter.]

I asked one economist that question and he said he would take the job if the President would just promise him he would be the last chairman of the Federal Reserve Board and he could abolish it.

Mr. **Lesher**. I would not go that far. I believe that the stated purpose of the administration and the Federal Reserve is very much in order. I believe it is a very difficult job to have a handle on the money supply at all times. The data come in well after the fact. But so long as they continue to do their best to attempt to hold down the growth of the money supply and have a stable hand on the tiller, let's just hope they get a little bit better in the actuality.

Senator **Symms**. Well, do you think with all the modern computers and technology that we have—why can't they come a little closer to their money targets?

Mr. **Lesher**. I don't know the answer to that. But I believe that their targets are in order, their policies are in order, and we would encourage them to continue on the track that they are on.

Senator **Symms**. What's the explanation, though, for when the real rate of inflation is 5 percent—it has been the last several months—and the prime rate is say 16 or 17 percent? Why the big difference?

Mr. **Lesher**. You ask several different people that question and you will get several different answers. My belief is that part of that is due to the extraordinary cost of funds because we have fundamentally altered our financial institutions. And the cost of funds is substantially higher than at any prior time in history. Notwithstanding that, I do believe that that problem is aggravated by uncertainty in public policies. And this is what I referred to earlier by stating the beauty of last year's tax actions cast a degree of stability because we forecast a 3-year stable tax program. Now, every day, there's a new proposal which casts more uncertainty on financial markets.

Senator **Symms**. But don't you think that also part of it is just a matter of confidence? That the public is waiting to see whether Congress is really going to address the issue of 60 percent of the budget going out for entitlements, escalating toward 90 percent?

Mr. **Lesher**. The third part of my answer is that I believe the general public is a lot smarter than some people give them credit for. And they are concerned about spending because they know that spending has been increasing and will continue to increase under present programs. Notwithstanding all the talk about spending reductions, Federal spending, as you know better than I, continues to leap forward dramatically. And the general public and the financial markets are concerned about that.

Senator **Symms**. Dr. Walker.

Dr. **Walker**. I agree with what Dr. Lesher has said. I simply want to emphasize one point. The people who make the basic decisions on buying or selling long-term securities, Government bonds, et cetera—and these are not the people on Wall Street that you see on the front page of the New York Times or the TV rushing around in all the ticker tape and so on. These are the men and women who run the investment accounts for pension funds, insurance companies and trust accounts of commercial banks. These are the key people. And they are simply not convinced that the decline in the inflation rate, which is very substantial, is real and won't go away. They are afraid of two things. First, they are afraid of the huge, triple digit deficits that loom ahead. Second, they are afraid that political pressure is going to force the Fed back into a politically motivated, excessive expansion of the money supply. They were burned all through the 1970's in that respect, and they are not going to be burned again.

Dr. Milton Friedman gave me another piece of information to help explain why real rates of interest have stayed so high. He said that in practically all other situations where hyperinflation dropped off sharply, the real rate of interest stayed high for a considerable period of time as the economy moved down the inflation scale. Expectations don't change as fast as those figures change.

Senator SYMMS. Did you have something you wanted to put in the record, Senator?

Senator GRASSLEY. No.

Senator SYMMS. Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman. Gentlemen, I wonder if we could be a little more precise about this. Everybody wants to lower the deficit. Let's take CBO's figures. CBO estimates that the deficit for fiscal 1983 would be $176 billion; fiscal 1984 has a deficit of $206 billion; and for fiscal 1985, $226 billion. That's assuming no change in the law. And I think that's a fair basis on which to begin because it is problematic whether Congress is going to change the law, cut further, whether it's domestic spending, entitlement expense, or revenue.

Now what happens if Congress does not make any significant further cuts in spending? As you know, Senator Grassley talks about a freeze only of 1982. Senator Hollings' is a freeze. The authorizing committees in the Congress in both the House and the Senate and there are reports that the Budget Committee recommends no further cuts in 1982 in their estimates to the Budget Committee. So for a practical matter, I think it is safe to assume that there may not be any major cuts—further major cuts—in domestic spending alone.

Now let's take defense. The President does not want any cuts in defense spending. He has stated that very clearly time and time again. He has also stated that he doesn't want any changes in the entitlement program. He is pushing it off onto the Commission until next year. So what is going to happen? Where are we going to cut? How are we going to find the areas to cut to get that deficit down?

Mr. LESHER. The testimony this morning was to suggest that some of us at least believe that there should be substantial cuts in virtually all parts of the budget, including the rate of growth of Federal spending in the Defense Department.

Senator BAUCUS. Let me back up a little bit. Assuming that CBO's estimates, $176 deficit for 1983, is correct, how quickly or how much do you want to cut that deficit beyond what is projected at this point?

Mr. LESHER. I would not accept CBO's estimates of that deficit. Their track record has not been very admirable in forecasting either the deficit or economic growth.

Senator BAUCUS. Well, I don't want to argue, but they are much better than the administration's in this regard. I will tell you that.

Mr. LESHER. I don't think that's correct.

Senator BAUCUS. It is for the deficits for fiscal 1982, 1983. We are not in 1983 yet, but it certainly is for 1981, 1982.

But anyway, let's just take the CBO estimates because the Congress will take those deficit numbers. Not only that, I think most people in the country take those figures more than they take many other estimates, as a general rule. Just for the sake of argument so we know where we are starting from, how much would you cut from that deficit? How quickly? What year? Dr. Walker.

Dr. **Walker**. I would like to see the deficit begin to move down. For fiscal 1983, which is a recession year, I would hope to take as a target, the President's mark of $91.5 billion. And, I think there are revenue actions and spending cuts that are possible to get close to that figure. But, more importantly, from there on, in 1984-86, we must show real progress in bringing down those deficits.

Senator **Baucus**. Well, let's assume that Congress does not make further cuts in domestic spending.

Dr. **Walker**. Then you won't make it.

Senator **Baucus**. Then where do you recommend Congress go to get that deficit down, to cut it say 20 or 30 percent?

Dr. **Walker**. I just cannot contemplate that, sir.

Senator **Baucus**. Let's say if. If there are no cuts beyond 1982 spending levels in domestic spending alone, give or take a few billion dollars, where do you think Congress should go to get the deficit down?

Dr. **Walker**. I do not think you should cut defense spending. I wear another hat as a chairman of a group called The Committee on the Present Danger. And in 1980, we drew up a defense program—and this wasn't just throwing dollars around——

Senator **Baucus**. We don't have much time. I am just trying to narrow this down.

Dr. **Walker**. I'm trying to answer your question.

Senator **Baucus**. All right. If not defense, then where?

Dr. **Walker**. You cannot do it if you rule out all domestic spending. It is just impossible.

Senator **Baucus**. If it is not defense, and I think it is fair to say this Congress is not going to make further substantial cuts in domestic spending, and if it is not defense, that leaves only entitlements and revenue.

Dr. **Walker**. I included entitlements in domestic spending. The Congress must take action on entitlements spending.

Senator **Baucus**. But how are we going to move if the President doesn't want to move?

Dr. **Walker**. I cannot say what the President and the administration will do ultimately, but this is a very early stage in the negotiations. The President has made quite clear that he wants to see what the Congress proposes.

Senator **Baucus**. Well, the President proposes the budget. Don't you think the President should propose changes in entitlements?

Dr. **Walker**. He proposed the budget.

Senator **Baucus**. But he didn't propose any changes in entitlements.

Dr. **Walker**. No, Senator, I think he proposed some changes in entitlements.

Senator **Baucus**. Not specific.

Dr. **Walker**. No, sir, they were not specific.

Senator BAUCUS. Not in the way you are talking about. No. Don't you think the President, if you are going to be consistent, should propose a change in the entitlement programs?

Dr. WALKER. If I were the President, I would stay right where I am right now, and wait and see whether a bipartisan coalition in the Congress can unite behind a plan that has every chance of passage.

Senator BAUCUS. Now I am not saying this is going to happen. Let's assume the President does not come forward. And let's assume, therefore, Congress does not make significant cuts this year, an election year, in entitlements. And let's assume further that you do want the deficit reduced. Where do we go? What's left?

Dr. WALKER. I don't think you have any place to go except try to defend yourself against continued high interest rates and inflation.

Senator BAUCUS. Do you disagree with Paul Volcker who says that in the matter of pure fiscal analysis, it doesn't make much difference whether you cut spending or raise revenues for the purpose of getting the deficit down and to get interest rates down.

Dr. WALKER. I didn't know my old friend, Paul Volcker had said that. If he did, I would disagree with him. Whether you cut spending or raise taxes in order to reduce the deficit makes a big difference.

Senator BAUCUS. He preferred to having spending cuts, but he also said that if you don't cut spending, but if you raise revenue to get the deficit down, that will have a very positive effect in getting interest rates down. Do you disagree with that statement?

Dr. WALKER. No; I don't disagree with the statement provided you get the spending down. If you just raise taxes and let spending go up, we are in the same old ball game we have been in for the last 20 years.

Senator BAUCUS. All I am trying to draw out here is agreed to which the rollback to some extent of the tax program will also reduce the deficit and, therefore, have a very salutary effect on interest rates. Mr. Lesher seemed to say that that would have no effect on interest rates.

Mr. LESHER. And we disagree very strongly with the proposition that you are putting forth.

Senator BAUCUS. You disagree with Paul Volcker.

Mr. LESHER. Yes, we do. We believe that history shows that when you reduce tax rates, you get a revenue increase to the Government. We believe that it is time to take a little longer view of things than just this once or this year's politics and economics. We believe very strongly in a reduction——

Senator BAUCUS. What do you say to all those people who are out of work? In Western States and forest product industry States where unemployment is 12 or 15 percent. People don't have jobs. They can't pay taxes. They want to pay taxes, but they can't pay taxes because interest rates are so high, housing is down, auto industry is down, cars aren't built. What do you say to those people? Just hang in there. In another 2 or 3 years things are going to be OK. What do you say to those people?

Mr. LESHER. What I would say to them is that the fundamental proposition on which this country is founded is the minimization of the role of government. If you minimize government spending and government taxes, you will get economic growth and job creation. For the first time in the history of man, it happened in this country based on so-called supply-side economics at the time the country was founded. It is time to return to those basic principles. I believe that that man and that woman standing in that bread line will agree with you if you take the message to them. Our polls show that they do agree.

Senator BAUCUS. Don't you think, though, that perhaps it makes more sense to moderate this program a little bit so that people can work a little bit? More people can get jobs again. Rather than going cold turkey so quickly.

Mr. LESHER. We believe very strongly that the arguments that you are making have been made for 30 years and they have failed repeatedly, time and time again. And all you do is guarantee the next recession will come sooner and be deeper.

Senator BAUCUS. Well, the argument I am making is to balance the budget. You are opposed to that?

Mr. LESHER. The argument you are making is to increase taxes. That is our difference of opinion today.

Senator BAUCUS. No; I'm trying to ask you what you would do if Congress doesn't make these spending cuts. I'm trying to find out if under any circumstances we should raise revenue.

Mr. LESHER. I am saying that in the longer run, if you take the longer run view, you are not talking about a viable option because increasing taxes will decrease economic activity.

Senator BAUCUS. Well, my time has run out. Thank you very much.

Senator SYMMS. Thank you very much. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman. I would like to ask a question of Mr. Brophy and Mr. Walker. Since time is short, I would appreciate if you could make the answers brief.

Regarding the safe harbor leasing, we had a discussion yesterday on the subject. We had witnesses from Eastern Airlines, Phelps Dodge, Scott Paper, and a steel company. They are very strongly in favor of the sale of the tax credits for businesses in their situation, that is, where they are not making money. Then we have the other side of the coin. Those who buy the credits. We haven't had witnesses from them, but unquestionably the news articles concerning General Electric or Occidental Oil or whomever it might be have not been helpful to the cause. What is your solution to the problem that we on this committee are presented with here? Taxpayers, individual taxpayers, see their taxes remaining constant or at best, going down 5 percent last year and 10 percent this year, but then they pick up a news article and see General Electric not only will pay no taxes but will receive a refund from last year. What do we do? What is your recommendation—stay steady on the course or make some changes in this safe harbor leasing program?

Mr. BROPHY. The recommendation of the business roundtable is that there be some changes made in that safe harbor leasing provision in order to eliminate the abuses, or perceived abuses, because we do recognize that you have a public perception problem. We also recognize that we have some basic infrastructure industries that are in serious economic trouble, and require help, and that the safe harbor leasing is part of that help. And, therefore, we have not taken the position that safe harbor leasing should be eliminated.

Senator **Chafee**. Do you, Mr. Brophy, in your statement—unfortunately, I wasn't here for the presentation of your statement—cover the business roundtable recommendations?

Mr. **Brophy**. Yes; I do.

Senator **Chafee**. In the statement?

Mr. **Brophy**. In the statement.

Senator **Chafee**. I see. Could you briefly outline what they are? Do they permit any company to buy enough credits to get its tax liability down to zero perhaps? Certainly it seems to me they shouldn't be retroactive to cover past tax liabilities or get a refund.

Mr. **Brophy**. When I say we have covered them, we have covered the general principle. We have not dealt with specifics, because we believe that that is something the Treasury Department, working with the Congress, should come up with recommendations on. We haven't seen the results of the studies that have been made. We are not really sufficiently familiar with how the safe harbor leasing has been actually used to make a specific recommendation at this time, but we will continue to study that.

Senator **Chafee**. Thank you. Dr. Walker.

Dr. **Walker**. Senator, we do have some information on safe harbor leasing that was submitted to the committee yesterday. This study prepared by Arthur Andersen & Co., gives some strong evidence concerning the efficiency of the safe harbor leasing provisions. In responding to you now, I am speaking strictly for myself, not the American Council.

With respect to the GE situation, as a buyer, the Arthur Andersen study indicates that the yield to buyers in safe harbor leases which are representative of those actually completed exceeds the breakeven rate by about one percentage point. The survey also showed that some sellers are receiving better than 95 percent of the maximum tax benefits associated with equipment ownership through safe harbor leasing.

Senator **Chafee**. Dr. Walker, I am not so interested in all these statistics. We've got a perception problem.

Dr. **Walker**. I understand.

Senator **Chafee**. Headlines read, "GE Pays No Taxes; GE Gets a $90 Million Refund." People ask, "What is going on?"

Dr. **Walker**. May I address that?

Senator **Chafee**. Right.

Dr. **Walker**. The point I was trying to make is that if the press gave the whole story of the GE situation, it wouldn't be quite that bad. However, I think Congress should consider a cap on the degree to which a company can, through buying, reduce its tax liability. Consideration should also be given to preventing a carry back of tax benefits from the provisions. However, the fact remains that the press is reporting only part of the story on safe harbor leasing.

Senator **Chafee**. You've heard the President speak on that. We can always eliminate the carry back. Maybe the story is a good one, but we have perception problems. Somebody once told me it's not what the facts are, it's what the people think the facts are.

Dr. WALKER. I think a cap on buyers' reductions in tax liabilities would be a good approach to the perception problem and would prevent possible abuses from occurring.

Senator CHAFEE. The witnesses yesterday indicated there are enough buyers out there so that if a cap is imposed, there are still enough buyers around.

Dr. WALKER. The market has been a strong sellers' market.

Senator SYMMS. How much of a cap do you mean?

Dr. WALKER. The Arthur Andersen study indicates that the average buyer reduced his current corporate taxes by only about 40 percent, so a cap of 50 percent would probably be reasonable.

Senator SYMMS. Of the tax liability?

Dr. WALKER. Yes.

Senator SYMMS. For any individual company?

Dr. WALKER. Yes.

Senator CHAFEE. Any other thoughts on that subject? What do you think if we eliminated it?

Dr. WALKER. If you eliminated it? There are two aspects to that. First of all, this is the first recession in history where we not only had tax cuts in effect as it began, but we had a specific tax cut through safe harbor leasing where hundreds of millions of dollars are going directly into the weakest sector of the economy. If you eliminate that now, you are going to be raising taxes on automobiles, on steel, on airlines, on railroads, on utilities, and so on. And that, I think, is a very difficult thing to justify.

Second, if you do eliminate safe harbor leasing, the survey shows that many companies are going to go back to the traditional leveraged leasing, which has existed for many years. The disadvantage of leveraged leasing is that it passes through only 55 percent of the benefits versus the 95 percent passed through with safe harbor leasing.

Senator CHAFEE. My time is up. I hate to cut you off. You are strongly opposed to eliminating this provision. That's the Walker position.

Dr. WALKER. That's a fair statement.

Senator CHAFEE. Thank you. I don't mean to cut you off, but we have other witnesses coming in. The way this system seems to work, make sure you get on an early panel.

Senator SYMMS. Senator Grassley has requested to ask a few more questions. I hope we can move along. This has been a very excellent panel. But I would just like to say one thing. I know there is a perception problem. But we do have, I think, a fairly good tax policy in place. And I am one member of this committee that is not going to let the media write the agenda for me. Because I think, unfortunately, many of those writing the stories don't understand the economic situation. If they do understand it, they are not putting it out. Because I think one of you said in your statement that people pay taxes and business collects taxes. That's true. And if they tell that side of the story, it's a little bit irrelevant whether there is leasing going on. That's another question. But it is not going to have an impact on the working man and woman in the country to lessen or increase their taxes. They will pay it one way or the other.

Senator Grassley, did you have one more question you wanted to ask or something you wanted to put in the record? We are falling behind.

Senator **Grassley**. Each one of you gentlemen have your own ideas as to what ought to be done. And, of course, each Member of Congress does too. We have all expressed different points of view here. But the problem is getting a concensus. And it seems to me like we are battling this perception of fairness. So I want to get back to what I suggested about an across-the-board approach to spending reductions based upon decisions that were just made within the last 4 or 5 months as we came up to the continuing resolution.

Wouldn't this be a good way to achieve a consensus and successfully challenge this perception of unfairness we have received. First of all, it addresses criticisms of the President's approach specifically that he is unquestioning in what he gives defense as opposed to domestic programs. Secondly, won't this approach answer criticisms that the third year that comes on the tax cut be eliminated so we can adopt a policy like what Dr. Walker suggests and not change the business portion of the tax reductions.

We have these perceptions that we have to deal with as elected officials. Often this keeps us from getting a consensus. Is the concept of an across-the-board approach an answer to this?

Dr. **Walker**. Sir, I would have difficulty freezing defense spending at 1982 levels. But you mentioned the continuing resolution. Now I think the continuing resolution is higher than the 1982 level. But I would have trouble with that freeze. I think it would be dangerous.

Senator **Grassley**. Mr. Lesher.

Mr. **Lesher**. I think I've already stated that your idea has merit despite some of the difficulties. And I do believe that there are some minor difficulties on the tax side, that the fine tuning should take place. But we believe that your bill contains the retention of the 1981 Tax Code. Through the next 3 years, we favor that very, very strongly. We believe that every effort must be made to reduce spending throughout the Federal Government. And your focus on that, I think, will help everyone to focus on that problem.

Senator **Grassley**. OK. My last point deals with the whole issue of tax increases. And I don't question the sincerity of those of you who say that maybe we ought to adjust the 1983 tax cut for individuals to bring in more revenue. I don't believe that it will accomplish what you want to. Doesn't a tax increase just delay the political pressure on Congress to make the adjustments in COLA's and in entitlements that you gentlemen agree we ought to make? In the same breath, you suggest that we forgo a 1983 tax reduction as one way of bringing about a reduction of the deficit. Aren't you really retarding the ultimate goals that you want to seek?

Mr. **Brophy**. Senator, if I can address that since I made the suggestion. I believe we are faced with a situation that even on a best-case basis we see deficits in the outyears that are unacceptable. Assuming that we can make the deepest level of spending cuts that any of us can imagine, we still have a great deal of uncertainty that we are facing. And we believe that it's important that the financial markets have a credible program for a substantial downtrend in the deficits in the outyears. We believe that that will be of greater benefit to the average man on the street and to the stimulation of the economy than anything else. We are surely not suggesting that we stretch the third year cut rather than make these cuts in spending. Just to the contrary. We would be unalterably opposed to a third year stretchout unless Congress is also willing to address these difficult problems, such as entitlements.

I think that that has to be part of an overall compromise package or the thing will not go.

Senator GRASSLEY. Well, then you would not support changing the individual tax reductions unless it's coupled with a dramatic increase in expenditures?

Mr. LESHER. Very definitely.

Mr. BROPHY. Decrease in expenditures.

Senator GRASSLEY. Decrease in expenditures.

Mr. BROPHY. Yes, sir.

Senator GRASSLEY. All right.

Senator SYMMS. All right, gentlemen. Thank you very much. We appreciate it.

The next panel is Mr. Clarfield of the Olin Corp.; Mr. Rinta of the State Chambers of Commerce, and Mr. Charles Potter. Now gentlemen—and I say this for the later panels—we are going to have to move right along here. I want to make sure that the later witnesses have their chance. So this panel will be allowed 20 minutes total. And you can present your evidence, your statements, but whoever speaks longest is just depriving the next speaker from it. So the clock starts now. Why don't you start, Mr. Clarfield.

STATEMENT OF WALLACE J. CLARFIELD, VICE PRESIDENT, TAXES, OLIN CORP.; CHAIRMAN, POLICY COMMITTEE OF THE TAX COUNCIL, WASHINGTON, D.C.

Senator CHAFEE. Why don't you summarize your statement. We have a copy of it. I am interested in what you have got to say.

Mr. CLARFIELD. All right. I am Wallace J. Clarfield, vice president, taxes, of the Olin Corp. of Stamford, Conn. I appreciate this opportunity to present a brief statement on behalf of the Tax Council, which I serve as chairman of the policy committee, and a member of its board of directors.

The council statement can be summarized as follows: We do not believe that the midst of a sharp recession is a time to raise taxes on either individuals or corporations. We believe the proposed minimum tax on the corporate sector, in particular, would be a counterproductive measure and should not be adopted. We support the administration's request for increased IRS audit capacity to improve tax compliance. The Congress should consider new tax burdens only if deficits in future years beyond fiscal 1983 are actually expanding and only after all possible efforts to reduce the growth of the major entitlement spending programs have been made.

Senator CHAFEE. I think that the fourth point is being met. The deficits in the years beyond fiscal 1983 are expanding. The outyear deficits are greater than the anticipated deficit for this year, at least by CBO projections.

Mr. CLARFIELD. Well, that's as of now, Senator. We are talking about reality and what happens if the economy picks up. And if the President's program works, and economic activity increases substantially it may be that those deficits will decrease; not expand.

Senator CHAFEE. What I fear is reality is going to make the deficits even worse. Receipts will not come in according to projections; Congress will not make the cuts in the domestic spending programs—in domestic, nondefense spending—to the extent that the President anticipated. But go ahead.

Mr. CLARFIELD. The council strongly supported most provisions of the Economic Recovery Tax Act of 1981. We remain convinced that the principal decisions under that legislation, particularly the individual rate reductions, the accelerated cost recovery system, tax relief for R. & D., and the permanent savings incentives will bear substantial fruit in revitalizing the private sector in the years to come.

Obviously, we are in a sharp recession now with no sign of real recovery in sight as yet. Mainly because of the recessionary shortfall in revenues, this has produced a such higher budget deficit for fiscal 1982-83 than anticipated earlier.

Senator CHAFEE. Why don't you summarize this, Mr. Clarfield? Can you?

Mr. CLARFIELD. As far as the minimum tax goes, we have opposed that concept on corporations consistently. We view the minimum tax as an artificial and unwarranted penalty on the employment of tax relief provision, that by themselves are considered appropriate and constructive. There is no economic rationale for the minimum tax, particularly as applied to the corporate sector.

Senator CHAFEE. Well, would you agree with the theory expressed by the prior panel that companies should not be able to buy these tax credits—safe harbor leasing—to bring their tax down to zero?

Mr. CLARFIELD. No, sir, I do not agree with what they said because they only told half the story. And, unfortunately, the news articles about GE only tell half the story. From the beginning to the end of the leasing program that GE has entered into, GE will actually lose money. They make money on the use of the funds they get at the front end of the program. That's the benefit that any lessor gets in the leasing program. But on a static basis, without taking into account the use of money, every one of those deals is basically uneconomic. That is, you pay more in taxes.

Senator CHAFEE. You mean GE is doing this as a charitable endeavor?

Mr. CLARFIELD. No, sir. I said what they are getting out of it is the early use of money. And that creates a profit for them. But when the newspapers indicate that they have reduced their taxes by $100 million, they will increase their taxes by $100 million in subsequent years. The advantage they have is that they have gotten the use of that money now. That's the whole idea behind the leasing program, and it is not a windfall except to the extent that some people argue if you——

Senator **Chafee**. Well, I'm not saying it's a windfall. I'm saying GE goes out and buys these credits. They are providing a service. By buying these credits, they provide a market for Eastern or whomever in which to sell them. I'm not saying GE is getting away with something. All I am saying is the public perception of a major company paying no taxes and, indeed, getting a refund for prior years, is counterproductive, I believe, in the efforts we are making in this country.

Mr. **Clarfield**. I agree. The problem, I think, is public relations rather than the law itself.

Senator **Chafee**. Well, GE has a pretty good public relations capacity, and they weren't able to get this message across.

Mr. **Clarfield**. Yes, sir.

Senator **Chafee**. Go ahead with what you have got.

Mr. **Clarfield**. As far as other revenue enhancers, the administration put forth a number of proposals to raise revenues. Most of them relate to specific industries and we will not comment on those. We do support an increase in revenue agents and compliance capability of the Internal Revenue Service. We think that that will raise substantial amounts of money.

We think as to the future that neither the Congress nor the administration has to come to grips really with the core problem behind the pre- and post-recession deficits. That is simply the continued expansion of major indexed entitlement programs. To date, the cutback on the spending has disproportionately fallen on other areas of the budget.

Senator **Chafee**. Well, don't say the Congress hasn't wrestled with it. The President, as you know, is refusing to make any change in the biggest indexed program of all, the biggest entitlement program of all—the social security. Well, I guess you do say that neither the Congress nor the administration has come to grips with this problem. You share the blame. OK. I apologize. You've got that.

Mr. **Clarfield**. We think that very significant additional budget savings to narrow future deficits can be found by spreading the expenditure-control efforts to slow the growth of these programs. If after all possible expenditure-control efforts have been made, and deficits in future years beyond fiscal 1983 are still expanding rapidly, consideration should be given to increasing taxes as a last measure. Any such increase should leave the post-ERTA structure of the income tax system in place. Let's not take away what we gave last year.

Thank you.

[The prepared statement follows:]

STATEMENT OF WALLACE J. CLARFIELD
ON BEHALF OF THE TAX COUNCIL
ON TAX INCREASE PROPOSALS
BEFORE THE COMMITTEE ON FINANCE
U.S. SENATE

March 19, 1982

I am Wallace J. Clarfield, Vice President-Taxes of Olin Corporation of Stamford, Connecticut. I appreciate this opportunity to present a brief statement on behalf of The Tax Council, which I serve as Chairman of the Policy Committee and as a member of the Board of Directors. The Tax Council is a non-profit business membership organization concerned with federal tax policy. Our members represent a wide range of business enterprise including heavy and light manufacturing, energy, mining, transportation, public utilities, consumer products and services, retailing, public accounting, banking, and other financial services.

The Council's statement can be summarized as follows:

1. We do not believe that the midst of a sharp recession is a time to raise taxes on either individuals or corporations.

2. We believe the proposed minimum tax on the corporate sector, in particular, would be a counter-productive measure and should not be adopted.

3. We support the Administration's request for increased IRS audit capacity to improve tax compliance.

4. We should consider new tax burdens only if deficits in future years beyond fiscal 1983 are actually expanding and only after all possible efforts to reduce the growth of the major entitlement spending programs have been made.

Economic Context

The Council strongly supported most provisions of The Economic Recovery Tax Act of 1981. We remain convinced that the principal decisions under that legislation, particularly the individual rate reductions, the Accelerated Cost Recovery System, tax relief for R&D, and the permanent savings incentives--will bear substantial fruit in revitalizing the private sector in the years to come.

Obviously, we are in a sharp recession now with no sign of real recovery in sight as yet. Mainly because of the recessionary shortfall in revenues and increases in mandated spending, this has produced a much higher budget deficit for fiscal 1982-1983 than anticipated earlier. Substantial deficits are projected for future years, and under certain assumptions these deficits would widen considerably. Now, however, the recession is accounting for three quarters of the fiscal 1982 deficit, and according to the Administration projection, two-thirds of the fiscal 1983 deficit.

Hopefully, recovery from the recession will set in later this year. But there is no assurance that it will be strong enough to raise economic activity to any satisfactory level in fiscal 1983, which starts only six months away. Depressed levels of corporate earnings will continue to be a drag on capital spending and employment. Sales of major durable goods industries are likely to continue sluggish through much of fiscal 1983.

In this context we don't think it makes sense to raise burdensome new taxes on either corporations or individuals. In fact, with bankruptcies on the rise, the threat of new taxes may become just as disruptive of business confidence and the health of financial markets as the fear of future budget deficits. One of the principal objectives of The Economic Recovery Tax Act of 1981 was to instill a greater sense of tax policy certainty for both business and individual taxpayers. Financial and investment planning could count on a given direction in tax policy over a prolonged period. Of course, investment planning is being adversely affected by high interest rates and the current recession, but it is also threatened by new tax burdens that would negate a large part of the tax relief under ERTA. This will do nothing to encourage new investment and employment.

The Minimum Tax

The Council consistently has opposed the concept of a minimum tax on corporations, regardless of its reach. We have viewed the minimum tax as an artificial and unwarranted penalty on the employment of tax relief provisions that by themselves are considered appropriate and constructive. There is no economic rationale for the minimum tax, particularly as applied to the corporate sector.

There is the possibility, of course, that through interaction of various tax provisions, some corporations will pay very low, or even zero, effective rates of tax. If it is deemed to be a critical national objective that all corporations pay a significant income tax, there is some political justification for the corporate minimum tax. We just don't believe this to be a pressing issue now or before. The existing minimum tax, in fact, was brought in as an afterthought by a Senate amendment to the 1969 Tax Reform Act. The original Treasury papers and studies which gave rise to most of the provisions of the 1969 Act recommended against a corporate minimum tax on the basis that it could not take into consideration the particular circumstances and problems of different industrial sectors calling for particular tax treatment. And that is precisely the problem with the existing minimum tax, which has had most of its impact on companies and industries with low earnings in depressed markets. Clearly, if there was no perceived need to reduce the budget deficit, the minimum tax would not have been proposed in the name of "distributional equity" for the corporate sector.

Even if one is taken with the notion of enforcing a "fairer" distribution of corporate tax liabilities, the minimum tax approach is a badly flawed tool. It is discriminatory in several ways. Its revenue yield to a large extent depends on retroactive application to past investments entered into, of course, without calculation of a minimum tax liability, especially in the case of depreciable assets, leases, and tax-exempt obligations. By including a set number of so-called "tax preferences" in the base, the minimum tax discriminates arbitrarily between those businesses employing a few such preferences on a relatively large scale and those that use a relatively large number of relief provisions not included as preferences but whose total tax reduction from relief provisions could be approximately the same. The only way to "correct" this would be to include all so-called corporate tax preferences, or tax expenditures, in the tax base--a completely unworkable arrangement.

The tax would certainly complicate business tax planning. It could encourage uneconomic mergers or discourage necessary rescues of failing firms to avoid triggering of the minimum tax. It would involve numerous administrative problems in any event.

The Administration's revenue estimates for the new minimum tax rise from $2.3 billion in 1983 to almost $5 billion in 1984 and cumulate to $19 billion over the next five years. This implies a significant new burden on corporate enterprise, assuming that Congress does nothing to expand the tax base and that it does not become a new "checkbook" for spending programs as well could happen. Most of the planned tax increase would involve restrictions on the employment of the investment credit and net operating loss deductions in direct contradiction to the investment incentive provisions of ERTA.

Now, as proposed by the Administration, the new minimum tax would be a true alternative tax to be paid in lieu of regular tax, if higher. This would be a structural improvement over the basically add-on present minimum tax. But there is no way to design any overall minimum tax, either an alternative or add-on, that will not adversely affect tax policy provisions that Congress has agreed upon and maintained as serving deserving national objectives.

Other Revenue Enhancers

The Council recognizes that a number of other proposals to raise new revenues effective in fiscal 1983 would have an adverse impact on the business sector. We take no position on the proposals applying to particular industrial sectors, but we oppose the further acceleration of corporate tax payments. This is a one-shot tax increase which would create substantial additional administrative burdens forever. It is simply not worth the temporary revenue gain.

The Council does support the Administration's request to increase the IRS audit capacity. We view this as a necessary move to improve tax compliance, and it could result in a substantial net revenue gain.

Future Years

Some projections of federal fiscal trends beyond fiscal 1983 show a worrisome widening of the budget deficit and an increase in its proportion to GNP well after the recession is expected to end. The Administration forecast itself concedes that we will have substantial deficits through 1987, although they maintain the trend will be downward assuming acceptance of its budget proposals. At this point it is simply impossible to design a budget and tax policy that would resolve all the fears of future deficits. One case could be made that future deficits are so huge as to require the elimination of all tax relief under ERTA if balancing the future budget is the only objective to be served. We do not believe we should plan our current national tax policy in such a self-destructing manner.

Neither Congress nor the Administration has come to grips really with a core problem behind the pre- and post-recession deficits. That is simply the continued expansion of the major indexed entitlement programs. To date, cutbacks on the spending side have disproportionately fallen on other non-defense areas of the budget and have barely scratched the major entitlement programs. Very significant additional budget savings to narrow future deficits can be found by spreading the expenditure control effort to slow the growth of these programs.

If after all possible expenditure control efforts have been made and deficits in future years beyond fiscal 1983 are still expanding rapidly, consideration should be given to significant tax increases as a last resort measure. Any such increases should leave the post-ERTA structure of the income tax system in place.

Senator **Chafee**. I'm not sure what you are saying. What taxes could be increased?

Mr. **Clarfield**. Well, we have not considered specific tax programs. And, consequently, we don't want to favor one versus the other. All we are saying is that any tax increase that Congress enacts should not negate any of the benefits that were given in the capital recovery benefits that were passed last year.

Senator **Chafee**. How about the individual?

Mr. **Clarfield**. Well, as somebody earlier testified, most of the tax benefits last year went to individuals. Some of those tax cuts, in fact, most of them, were geared toward either savings incentives plus rate cuts. We are not suggesting any changes one way or another. If taxes have to be increased then they should be increased for everybody. We are not singling out any sector of the economy for tax increases, Senator.

Senator **Chafee**. OK. Thank you, Mr. Clarfield.

Mr. Rinta.

STATEMENT OF EUGENE F. RINTA, FEDERAL FINANCE CONSULTANT, STATE CHAMBERS OF COMMERCE, WASHINGTON, D.C.

Mr. **Rinta**. My name is Eugene F. Rinta and I serve the Council of State Chambers of Commerce as consultant on Federal fiscal issues.

The only tax proposal discussed in my statement is the proposed new minimum tax on corporations, which we oppose. I have nothing to add to what other witnesses this morning have said about the proposal so I will limit my remarks to expenditure reduction.

The Congress, last year, made substantial progress toward bringing Federal spending under control. But much more needs to be done. Projected outlays in three spending categories are of particular concern because of their size and rapid growth. They are: entitlements, national defense, and interest.

In our appearance before your committee last spring, we urged consideration of means for restraining the cost impact of existing inflation adjustments on various entitlement programs. It's these adjustments which have been the major cause of the sharp increase in their cost in recent years. A number of methods for accomplishing this restraint have been proposed. For example, the budget plan proposed by Senator Hollings would reduce outlays for social security and Federal retirement programs by an estimated $19 billion in 1983 and $37 billion in 1985. It would freeze the COLA for these benefits in 1982, cap the social security COLA at the Consumer Price Index minus 3 percentage points for subsequent years, and limit the military and civil service retirement COLA at the lower of the social security COLA or the Federal pay-raise percentage.

As for defense spending, we do not claim competence to suggest any specific amounts of reductions. And we recognize that this is a matter under jurisdiction of other committees of Congress. But in view of projected huge budget deficits for several years to come, we do wish to express our concern over the projected growth of defense. National defense outlays projected in the 1983 budget would rise from $187 billion in 1982 to $292 billion in 1985 for an increase of 56 percent in 3 years. A further increase of $72 billion is projected from 1985 to 1987. Unless inflation is brought under control in this period, the planned defense program would cost even more. While we are not in a position to recommend specific program reductions, we do believe that signficant cuts could be made without seriously impairing the Nation's defense.

The growth of interest costs during the next few years will be determined by what Congress does about reducing projected budget deficits. The CBO baseline projections, based on existing legislation and CBO economic assumptions, show net interest at $106 billion in 1983 and rising steadily to $168 billion by 1987.

Deficits projected in the President's budget would decline gradually from $91.5 billion in 1983 to $53 billion in 1987. But the CBO baseline deficit projections show the deficit rising from $157 billion in 1983 to $248 billion in 1987. Actions taken now to reduce these deficits in subtantial amounts would have a twofold effect in reducing interest costs. In addition to the obvious reduction in interest costs that would result from the smaller than expected public debt, reducing the deficits would help to bring interest rates down. This would occur with reduction of the present large inflation premium in interest rates, as lenders' anticipation of future inflation recedes.

[The prepared statement follows:]

STATEMENT OF EUGENE F. RINTA
COUNCIL OF STATE CHAMBERS OF COMMERCE
before the
SENATE COMMITTEE ON FINANCE
March 19, 1982

My name is Eugene F. Rinta and I serve the Council of State Chambers of Commerce as consultant on Federal fiscal issues.

The Council is a federation of 34 State and regional business associations. The Federal Finance Committee is one of several standing committees of the Council which develop and recommend policies on legislative issues to its member organizations and to the Congress. Normally, the policy proposals submitted to Congressional committees are first referred to the member organizations for endorsement, but in this instance that procedure was impractical because of the short lead-time available. Accordingly, this presentation is being made only on behalf of our Federal Finance Committee which met on March 10 to consider the President's budget and tax proposals.

Summary

1. The proposed new minimum tax on corporations should be rejected because its adverse impact on several basic industries and new growth companies would retard economic recovery.
2. Existing inflation indexing of entitlement programs, including Social Security, should be revised to curtail the rapid growth of their costs.
3. The projected high growth rate of defense spending should be reduced.

Minimum Corporate Tax Proposal Opposed

A year ago we strongly supported the President's tax proposals which had the basic purpose of encouraging savings and investment by individual tax reductions and by more rapid recovery of capital investments than under then existing depreciation rules. These tax reductions and revisions were enacted in the Economic Recovery Tax Act of 1981 substantially as proposed. The Act also includes additional tax relief provisions deemed desirable by the Congress.

With the economy in recession and several basic industries in a severe slump, this would hardly seem an appropriate time to increase taxes. Of particular concern to us is the proposal for an alternative minimum tax on corporations. The Treasury estimates that total corporate tax liabilities will be increased 5% by the tax. But this additional tax burden will be borne by only 90,000 corporations whose taxes would be increased an estimated $2.3 billion in fiscal year 1983, $4.8 billion in 1984 and $4.5 billion in 1985.

Especially affected by the minimum tax proposal would be such depressed basic industries as automobile, mining and steel which would lose much of the benefits of the 1981 Act with respect to investments being made to improve their productivity. Also affected adversely would be emerging growth companies having relatively little taxable income under present law and needing all available cash flow for growth. Imposing new tax burdens on these depressed industries and new growth companies would only retard resurgence of the economy. We urge rejection of the corporate minimum tax proposal which would retard growth of budget revenues as well as economic recovery.

Expenditure Reduction and Control

The Congress last year made substantial progress toward bringing Federal spending under control. But much more needs to be done. Projected outlays in three spending categories are of particular concern because of their size and rapid growth. They are entitlements, national defense, and interest.

According to baseline outlay projections of the Congressional Budget Office (CBO) benefit payments for individuals, which are almost totally entitlements, account for 47% of estimated 1982 total outlays and they will increase 29% by 1985 under present law. It is this category, of course, which is a primary concern of the Committee on Finance since a major part of total entitlement outlays are within your jurisdictional responsibility.

In our appearance before your committee and the Committee on Ways and Means last Spring we urged consideration of means for restraining the cost impact of existing inflation adjustments on various entitlement programs. It is these adjustments which have been the major cause of the sharp increase in their cost in recent years. A number of methods for accomplishing this restraint have been proposed. For example, the budget plan proposed by Senator Hollings would reduce outlays for Social Security and Federal retirement programs by an estimated $19 billion in 1983 and $37 billion by 1985. It would freeze the COLA for these benefits in 1982, cap the Social Security COLA at the consumer price index minus three percentage points for subsequent years, and limit the military and civil service retirement COLA at the lower of the Social Security COLA or the Federal pay raise percentage.

We again urge your committee to revise indexing of entitlements under your jurisdiction, including the inflation indexing of Social Security benefits, to produce multibillion budget savings in the years ahead.

We do not claim competence to suggest any specific amounts of reductions in national defense programs at this time, and we recognize that this is a matter under the jurisdiction of other committees of the Congress. But, in view of projected huge budget deficits for several years to come, we do wish to express our concern over the projected growth of defense spending. For example, national defense outlays projected in the 1983 budget would rise from $187.5 billion in 1982 to $292.1 billion in 1985 for an increase of 56% in three years. A further increase of $72 billion, or 25%, is projected from 1985 to 1987. Unless inflation is brought under control in this period, the planned defense program would cost even more. While we are not in a position to recommend specific program reductions, we do believe significant cuts could be made without seriously impairing the nation's defense.

The growth of interest costs during the next few years will be largely determined by what Congress does about reducing budget deficits. Net interest costs in the 1983 budget are projected to vary relatively little during the 1983-87 period from the $96.4 billion estimate for 1983. The CBO baseline projections, however, show net interest at $106 billion in 1983 and rising steadily to $168 billion by 1987.

Deficits projected in the 1983 budget would decline gradually from $91.5 billion in 1983 to $53.2 billion in 1987. But the CBO baseline deficit projections, which are based on existing legislation and CBO economic assumptions, show the deficit rising from $157 billion in 1983 to $248 billion in 1987. Actions taken to reduce the projected deficits in substantial amounts would have a twofold effect in reducing interest costs. In addition to the obvious reduction in projected interest costs that would result from the smaller than expected public debt, reducing the deficits would help to bring interest rates down. This would occur with reduction of the present large inflation premium in interest rates, especially in longer term rates, as lenders' anticipation of future inflation recedes.

In conclusion, we urge the Committee on Finance to reject the proposed minimum tax on corporations because of its adverse effect on several major depressed industries, and to revise the indexing of entitlement programs, including Social Security, to provide substantial budget savings. We also urge your support of some slowdown in the administration's planned growth of defense spending.

Senator CHAFEE. Well, thank you very much, Mr. Rinta. The gist of your program, as I understand it, is some reduction in defense, and the dealing with the issue of entitlements which includes the social security COLA——

Mr. RINTA. That's right.

Senator CHAFEE. Do you know the President's position on that?

Mr. RINTA. I have heard it stated a number of times.

Senator CHAFEE. It's not politically the most popular program that you are espousing.

Mr. RINTA. That's very true. But if significant reductions are to be made in entitlements as well as the entire budget, that area has to be attacked.

Senator CHAFEE. All right. I appreciate your testimony. Thank you both, gentlemen, for coming.

The next panel is Mr. Holleman, National Constructors Association; Mr. Nolan—oh, Mr. Stewart, excuse me. I missed that. Mr. Stewart is up. And, gentlemen, you will be next.

All right. Mr. Stewart.

STATEMENT OF CHARLES STEWART, PRESIDENT, MACHINERY AND ALLIED PRODUCTS INSTITUTE, WASHINGTON, D.C.

Senator CHAFEE. All right, Mr. Stewart, we have your statement. I would suggest you summarize it. We can only allot 8 minutes to this testimony.

Mr. STEWART. Thank you, Mr. Chairman. I appear on behalf of the Machinery and Allied Products Institute which is the national organization representing the capital goods and allied product industries in the United States. Industries, Mr. Chairman, with which you are well familiar.

I will defer entirely to your time schedule. We do not view this hearing as primarily for the purpose of obtaining comprehensive plans to deal with estimated deficits over the next few years. And, therefore, our principal thrust of testimony relates to the so-called revenue enhancement recommendations of the administration.

However, I don't feel responsible in coming before the committee and dealing with those particular recommendations without saying something about the broad deficit problem and its relationship to interest rates. Contrary to some of the spirit of the first panel this morning, my own personal conviction and the conviction of my organization is that the deficits, as estimated, whether you take the CBO estimates or the administration's estimates or something in between——

Senator CHAFEE. Mr. Stewart, I apologize. We will have to recess for a couple of minutes here. I have to return an important call. I will be right back.

[Whereupon, at 10:34 am., the hearing was recessed.]

AFTER RECESS

Senator SYMMS. The committee will come back to order. And, Mr. Stewart, if you would like to start over again, I would like to hear your statement. And why don't you go right ahead. I understand the chairman gave you 8 minutes. You said you had used one, but we will get moving. He is on the phone with the President in there.

Mr. STEWART. I identified myself for the record, Mr. Chairman. And indicated that the principal thrust of our testimony relates to the so-called revenue enhancement measures submitted by the administration in connection with its budget.

I went on to say and I want to repeat that as a business organization representing a very broad sector of the American economy, we have a very, very serious concern about the high deficits. Perhaps our feeling on the subject is stronger than those of at least some of the members of the panel that started the morning for you. And we feel further, to be more specific with regard to the administration's position, that the estimated deficits, whichever estimates you take, are unacceptable. And, in addition, are not a proper price to pay for completely uninterrupted carryon of the program as outlined by the President in terms of his total economic objectives.

Now this does not mean that in any substantial way we differ with that program. But we do not feel that in a year of deficit estimation that is so serious one can say don't touch anything, don't do anything, just wait until the program works. Now although we are concentrating on the revenue enhancement measures, we do suggest some outlines of an approach for dealing with the deficits. They appear beginning with the second paragraph of page 3 of our statement and carrying over to page 4. And I won't trouble you with repeating those unless you wish to pursue them. But at least we feel that not only are the deficits unacceptable, but, second, they must be dealt with. And dealing with them in an intelligent fashion, hopefully with a joint effort on the part of the Congress and the President, will not in any serious way impede the ongoing progress and development of the President's program.

Now moving to the so-called revenue enhancement measures, we deal with only five. Two, we think, are most important. One, the recommendation to abolish legislatively and cripple in a regulatory manner the completed-contract method of accounting. And, second, the proposed alternative minimum tax, which is a modification in approach to the minimum tax that is already on the books.

We also express reservations about three other revenue enhancement measures. One is the industrial development bond recommendation. Two, the speedup in corporate tax payments. And, third, withholding on interest and dividends. Let's take the last two first, very briefly.

I don't think the Congress is going to seriously consider the proposal for withholding on interest and dividends. This is a tired, old turkey that has been on the Treasury list for I don't know how long. It will cause more disruption in terms of burden than it can possibly produce. It will penalize a lot of people that the Congress is interested in in connection with some of the perceptions that were referred to. And our view is that you ought to go the information reporting route if you want to tighten further in that area.

With regard to the speedup in the payment of corporate taxes, this final recommendation in a series over the years represents, in our view, an overreaching. Corporations cannot estimate down to absolute precision what their taxes are going to be. That's an illusion that the Treasury Department has. And, in our view, the last law that you passed in 1981 took us as far down this road of an attempted currency of payments as we should go.

Now those comments are thrown out in terms of trying to suggest—as is dealt with in more detail in our statement—that there are counterproductive aspects to both of these recommendations. The same thing applies to the third of the second group in terms of priority of recommendations of the President that we deal with in our statement. And that's the industrial development bonds.

This is controversial. It's been on the books. It's been before the Congress. There are certain favorable effects of this type of financing, particularly, in a time when the President wants to get things back to the local level.

However, there are certain parts of the Treasury recommendations with respect to tightening the procedures with regard to this type of financing in which we concur. And our statement spells that out.

Now, in conclusion, let me say a word about the two aspects of the President's recommendations about which we feel most strongly. On the matter of the completed-contract method, I think Treasury is queasy itself or it wouldn't have asked this Congress to repeal by statutory action a method which has been utilized and implemented by Treasury regulations over a very long period of time. There are special characteristics involved in long-term contracting. This is true whether the company is a constructor or a defense manufacturer or a builder of a big material handling system.

Senator CHAFEE. Mr. Stewart, we've just got to hold you right to the line here. You've got 30 seconds more.

Mr. STEWART. I will come within it. My final comment relates to the minimum tax. The minimum tax is wrong in principle and in concept. And we've developed this in two publications in November 1980 and previously in March 1977. If there are certain tax preferences on the statute books which should be modified or deleted, they should be dealt with directly, not through the back door by virtue of a minimum tax.

That concludes my statement.

Senator CHAFEE. OK.

[The prepared statement follows:]

Statement of the
Machinery and Allied Products Institute
to the
Senate Committee on Finance
Concerning
Tax Proposals in the Administration's Budget
March 19, 1982

SUMMARY

1. MAPI does not view this hearing as one seeking comprehensive plans to deal with the estimated deficits over the next few years as alternatives to the program of the Reagan Administration. We, therefore, concentrate on certain so-called revenue enhancement recommendations of the Administration.

   On the other hand, the MAPI testimony includes some observations on the deficit problem and how it might be addressed. In brief, we feel that more action than the President has recommended is necessary in order to deal with the twin problems of high deficits and high interest rates. Further, it is our judgment that such additional action can be taken without reversing nor in the long run impeding the extraordinary array of new and sound economic directions established by the Reagan Administration.

2. MAPI does not see any conflict between our strong views about the deficits and the need to moderate them and our comments on the revenue enhancement proposals presented in this statement.

3. Completed-contract accounting should be retained as nearly intact as possible subject to reasonable rules of cost characterization as among "period" and "attributable" items and reasonable rules of severability and completion.

   The Congress should reject outright the Treasury Department's request for repeal of completed-contract accounting.

4. The proposal for an alternative corporate minimum tax is almost as indefensible in principle as the existing corporate add-on minimum tax, and all such levies should be repealed. The minimum tax concept results in the negation or partial offset of tax preferences included in the Revenue Code for deliberate tax and public policy reasons.

5. Tax-exempt financing for so-called "private" activities should not be eliminated, and depreciable assets financed with tax-exempt bonds should not be relegated to straight-line depreciation. Also, for purposes of industrial development bond (IDB) financing, small-issue IDBs should be retained without any attempted distinction between "small" and "large" businesses.

6. The various proposals to speed up corporate tax payments would have the effect of requiring such taxpayers to overpay their liabilities in order to avoid penalties, and consequently should be rejected. The recommendation represents overreaching on the part of the Treasury Department and it assumes a precise estimating ability which is impossible to achieve, even by large and sophisticated corporations.

7. The proposal to have withholding of taxes on interest and dividends would burden unduly the financial affairs of many organizations and individuals (including the elderly), and should be abandoned. It would probably not be cost-efficient. In rejecting the proposal, the Congress should send the Treasury Department a message to delete the item for the foreseeable future rather than resurrecting it periodically.

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Introduction

The Machinery and Allied Products Institute (MAPI) is pleased to have this opportunity to comment to the Senate Committee on Finance on tax proposals in the Administration's budget, as announced in President Reagan's State of the Union address on January 26, 1982, and amplified in his Budget Message of February 8, 1982. Since the outlines of the Administration plan were made known, Treasury has published further explanations of the tax initiatives, and we will comment on both general and specific aspects of the program.

Regarding MAPI's interest in this proceeding, the Institute represents the capital goods and allied product industries of the United States, and engages both in original economic research and public policy representation aimed at advancing the technology and furthering the economic progress of the nation. In this capacity, MAPI has a direct interest in the federal government's fiscal, monetary, and regulatory policies, which, in turn, have a substantial influence on the nation's prosperity and its progress toward goals of increased real growth, increased employment, an improved defense posture, and reduced inflation.

MAPI does not view this hearing as one seeking comprehensive plans to deal with the estimated deficits over the next few years as alternatives to the program of the Reagan Administration. We will, therefore, concentrate on the so-called revenue enhancement recommendations of the Administration. On the other hand, we feel obliged to make some observations on the deficit problem and how it might be addressed.

The Seriousness of the Projected Deficits

By any generally accepted measure, whether it be the Administration estimates or those of the Congressional Budget Office, even allowing for implementation of certain recommendations of the President, as to tax initiatives for example, this country confronts very high and serious deficits. MAPI considers them to be unacceptable at the levels projected. The Administration takes the position that even after application of as much discipline as possible to government spending, and even assuming the adoption of its tax initiatives, the remaining high deficits are the price that must be paid for continuing in effect the basic elements of the economic program which the President has advanced and which in large part the Congress has adopted.

MAPI has no quarrel with, indeed we applaud, the basic directions shaped by the President and his Administration in reference to reductions in tax burdens so as to increase equity and improve savings and investment; elimination of other government disincentives to savings and investment to the extent appropriate; reasonably accommodative but stable growth in the supply of money and credit; the elimination of wasteful and otherwise unnecessary governmental spending; and a reduction in regulation of the private sector to the extent consistent with the public interest.

On the other hand, although we strongly concur in these objectives and endorse their continued implementation, we feel that the deficit situation and the related problem of high interest rates, coupled with what we perceive to be some erosion of confidence in the state of the economy, require more action than the President has recommended in order to deal with the twin problems of high deficits and high interest rates.

Having made clear MAPI's general concurrence in what we consider to be an extraordinary array of new and sound economic directions established by the Reagan Administration, we feel that those directions need not be reversed nor in the long run impeded by taking some tax actions at this juncture, coupled with further expenditure reductions, which will contribute to a reduction in deficits at least in the coming years. As already indicated, it is not our purpose to lay out a definitive program to meet the objective just stated. That function, we feel, must be a joint effort by the Executive and Legislative branches. Our intent at this point is to underline our feeling that such a joint effort is necessary, indeed critical. A whole range of alternatives which have been discussed by members of the Congress and public commentators are certainly worthy of consideration.

Entitlement programs, in our view and as Senators Domenici and Hollings have pointed out, must be addressed. A possible freeze in domestic discretionary spending might be considered. Increases in certain excise taxes certainly are worthy of careful study. A significant number of members of the Congress have suggested that certain provisions of the Economic Recovery Tax Act of 1981 should be reexamined. If that were to take place, we would certainly urge that any reductions in benefits be evenhanded as between corporations and individuals./1 This prompts us to observe more generally our feeling that if a significant reduction in the deficit beyond the spending cuts already recommended by the President--and realistically some of those may not be adopted--is to be

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1/ The legislative history of ERTA will show that MAPI was not only one of the strongest supporters for liberalized capital cost recovery allowances, but that we also urged that individual taxpayers be given substantial relief by across-the-board reductions in marginal tax rates.

achieved, a program which will impact a range of interests is likely to be necessary.

Further, although we are very much aware of the need for the United States to strengthen its national security, as we confront the overriding problems of high deficits and high interest rates, we do not believe that absolute protection can be given to the defense budget. Rather, at least some moderate and hopefully temporary moderation in defense expenditures should be considered. If approved, such a moderation should avoid unfavorable effect on improvement in maintenance and readiness.

Having said all this, let us return to the principal thrust of this presentation, the package of so-called revenue enhancement recommendations which the Administration has advanced and the Treasury Department has particularized. These recommendations are called revenue enhancement measures (REMs). This, of course, is a euphemism. For the most part they represent tax increases or have that effect. In this respect Administration rhetoric which opposes tax increases in general is inconsistent with the real nature of these proposals. As a matter of fact, tax increases are not only involved, the effects of certain of these recommendations are in conflict with the overall objectives of the Administration with reference to capital formation, savings and investment, etc.

At this juncture it is appropriate to reconcile our opposition to certain of these REMs with our strong views about the deficits and the need to moderate them. First, our views on the REMs are limited to five proposals so that by no means do we appear here in opposition to the entire package. Further, although we comment on five of these recommendations, we feel most strongly about two, namely, the suggested rescission of the completed-contract method of accounting for tax purposes and the newly formulated minimum tax recommendation. We also comment critically as to those REMs bearing on industrial revenue bonds, withholding on dividends and interest, and further speed-up of corporate tax payments. In these instances our purpose is to try to help ensure that the Congress in studying these three recommendations is aware of certain counterproductive results that will occur if the Congress conforms to Treasury views.

Finally, as we put in perspective our general comments about the deficits and high interest rates and our treatment of certain of the REMs now being considered by this Committee, we anticipate that the Congress will look at the tax proposals advanced by the Treasury Department as representing ideas for consideration in a broader effort to deal with the deficit-high interest rate dilemma. In other words, the REMs just represent one set of ideas which should be studied by the Congress as distinguished from being treated as a separable package of well-reasoned recommendations, which in many respects they are not.

Some specifics in brief.--As more fully described later, we have arrived at the following conclusions on certain of the proposed revenue enhancers:

1. Completed-contract accounting should be retained as nearly intact as possible subject to reasonable rules of

cost characterization as among "period" and "attributable" items and reasonable rules of severability and "completion" to ensure that contracts do not remain open indefinitely when there is no sound tax-policy reason for continued nonrecognition. The law should continue to reflect the principle that no tax will be due on a long-term contract until it is certain that taxable income--rather than a loss--is the result, whether advance or progress payments are received or not. In no case should period costs incurred with respect to existing or future long-term contracts be subject to a minimum tax on tax preferences.

2. We believe that the proposal for an alternative corporate minimum tax is--like the existing add-on corporate minimum tax--indefensible in principle, and would be an administrative morass. Whereas the change from an add-on to an alternative minimum tax, considered in isolation, would be unobjectionable, the underlying concept of the minimum tax itself is gravely defective and the Administration's proposal would extend and seriously complicate the original policy error. The corporate minimum tax, not to mention the same or similar levies applied to individuals, should be repealed.
3. We have reservations about elimination of tax-exempt financing for so-called "private" activities and believe that depreciable assets financed with tax-exempt bonds should not be relegated to straight-line depreciation.

Also, for purposes of industrial development bond (IDB) financing, small-issue IDBs should be retained without any attempted distinction between "small" and "large" businesses. We do not take exception at this time to the proposals for public approval; for a commitment by the sponsoring governmental unit; for registration and information reporting; or for increased arbitrage limitations--provided that each of the foregoing conforms to standards of fairness and administrability.

4. The speed-up of corporate estimated tax payments should not be pursued because corporations are unable to estimate their tax liabilities accurately prior to year-end and, even then, need the additional time currently allowed in which to gather information and carry out computations for that purpose. Moreover, the proposals to step up the percentage and pace of payments come directly on the heels of newly enacted law imposing significant changes of the same type. We will not endorse any plan that has the effect of requiring taxpayers to overpay their liabilities in order to avoid penalties.
5. The proposal to have withholding of taxes on interest and dividends has the dubious distinction of being the most consistently and resoundingly rejected idea for tax revision of the last eight decades. It has more potential for burdening the financial affairs of more organizations and taxpayers (including the elderly) than any other REM proposed, and should be abandoned.

Congress Should Reject Abolition of Completed-Contract Accounting Method and the Proposed Alternative Corporate Minimum Tax

CCM Accounting

The Treasury recommendations on completed-contract method accounting include a regulatory proposal and a legislative proposal which would repeal the method. Reading between the lines, it seems fair to observe that the inclusion of a recommendation for statutory repeal at least infers a sense of weakness about the CCM accounting recommendations and a feeling that without a congressional repealer, Treasury would be swamped with law suits. Such litigation presumably would contest the legality of overturning long-established and well-reasoned regulations permitting completed-contract method accounting on a fair and equitable basis.

The CCM regulations under Code Section 451 would be amended to restrict severely the listing of indirect costs that will qualify as period items; and to "clarify" the rules on severability, aggregation, and "completion." Based on changes that would be made to regulations under Code Section 446, taxpayers using the accrual shipment or accrual acceptance method of accounting for multi-unit contracts would have to accrue income upon shipment or acceptance of the various units and not the final unit. Regulations implementing Code Section 471 would be amended so that taxpayers entitled to use an inventory method for a long-term contract also would be required to use the costing rules set forth for the CCM.

A legislative proposal would (1) repeal the CCM; and (2) provide that taxpayers must elect to use either the percentage-of-completion method or the "progress payment" method of accounting for long-term contracts. The latter method would be new and would have most costs be allocated to long-term contracts and be deferred until the taxpayer has a right to receive payment under a contract. When the right to payment accrues, the taxpayer could deduct the total of the current and previously unclaimed costs allocated to a contract, up to the amount of the accrued payment. Accrued payments in excess of costs would give rise to taxable income, and certain borrowings in lieu of payment would be treated as payments.

Generally, the proposals would be effective for taxable years beginning after December 31, 1982. However, taxpayers could continue to use the current long-term contract accounting rules for contracts entered into on or before February 26, 1982, and the existing period cost rules could be followed for such contracts by taxpayers electing the cut-off method of change in accounting. After 1982, period cost deductions allowable under the transition but not permissible in accordance with the new requirements would be an item of tax preference subject to the corporate alternative minimum tax.

In general.--MAPI strongly opposes the proposed legislation to repeal the CCM and to require the use of the percentage-of-completion or the progress payment method of accounting. Furthermore, as to the proposed regulations, we believe that completed-contract accounting should be kept as nearly intact as possible, consistent with reasonable rules of cost characterization, contract severability, contract aggregation, and "completion." The law should continue to reflect that it is inequitable to require the imposition of a tax on a long-term contract before the taxpayer knows whether the contract has given rise to income or a loss. Further, the existence of advance or progress payments ordinarily has no bearing on this determination and, consequently, the accrual or receipt of such payments should not trigger income recognition. Finally, the minimum tax coverage of "excess period cost deductions" is inconsistent with our position on CCM costs generally and the minimum tax itself, and would amount to a "watering down" of the CCM transition rule for corporations that would be affected by the alternative minimum tax.

Consequences.--In MAPI's judgment, the CCM proposals would be damaging and counterproductive, as partially borne out by the Treasury's estimates of very sizable projected revenue gains to the government averaging some $4.0 billion per annum after the transition year. These revenues would be drawn from the cash flow of long-term contractors. They would be denied legitimate period cost deductions as incurred and would be taxed on accrued payments in excess of attributable costs regardless of the stage of contract completion and irrespective of uncertainties as to whether a transaction will be profitable or not. The tax policy implicit in the proposals is directly against the grain of policy that has been embedded in the federal income tax since 1918 and has not only "survived" periodic review but has been amplified, restated, and reaffirmed in deference to the circumstances of the long-term contractor to which it is addressed./1 Also, the proposal is at cross-currents with capital formation incentives of ERTA which would be more than offset in many instances by the CCM proposals.

Affected parties.--As to who would be affected, the answer is "long-term contractors" engaged in any eligible activity using the CCM or using inventory methods of accounting that are similar in their result. These are businesses with contracts that require a significant period of time from inception to completion and acceptance, and they typically entail high risk because of (1) the time to completion, and, in many cases, (2) "custom" or "state of the art" aspects of the contract subject matter./2 Among the risks that are greatly magnified in long-term contracting are those of supply interruptions, litigation, strikes, unforeseen changes in costs, inclement weather, delays of any kind beyond the control of the contractor, changes in technology or in applicable regulations and codes, adverse changes in credit availability and cost, change-orders initiated by the customer, and penalty clauses effectuated by events that were not anticipated.

Due to these types of risks along with customer retainages, the long-term contractor usually cannot know with any certainty the existence or magnitude of taxable income from a transaction until contract completion and customer acceptance.

1/ For a discussion by IRS of the reasons underlying the CCM, see Revenue Ruling 70-67, 1970-1 Cum. Bull. 117.

2/ MAPI's membership includes affected parties engaged in the manufacture and installation of many types of industrial and other machinery, including equipment that is custom-made; in construction; in advanced electronic systems for commercial applications; and in defense contracting.

Impacts.--In that connection, MAPI has engaged in some informal surveying to try to identify the potential impacts of the CCM proposals. The central concern of taxpayers is that some amount approaching or approximating the estimated provision for taxes payable upon contract completion would become due and payable in advance. Such an eventuality would siphon capital directly out of affected corporations and industries prematurely, and, even with a liberal transition rule could cause disruption and hardship. Almost universally, parties with whom we have spoken would have to "refinance" their lost capital in the credit markets, often under terms and conditions that would be relatively disadvantageous. Ultimately, they would hope to pass the increased costs to their customers in order to preserve acceptable profit margins and rates of return on invested capital, but their ability to do so and to compete in the future against companies not comparably burdened would be in doubt.

Having mentioned that ERTA benefits would be offset, we also note in the defense-procurement context that efforts of the Department of Defense to improve the "climate" for contractors on matters of profitability and progress payments could be nullified by the CCM proposals. We think it unfortunate that companies engaged in high risk, high priority, low margin activities would be asked to pay taxes on their transactions before their taxable income therefrom, if any, could be ascertained. Our sentiments about this are reflected in excerpts from a February 25, 1982 letter of Frank C. Carlucci, Deputy Secretary of Defense, to R. T. ("Tim") McNamar, Deputy Secretary of the Treasury. Although Secretary Carlucci was not wholly critical and conceded that

Treasury was the "lead" agency in establishing tax policy, he made the following deft observations:

> . . . [W]e are concerned about the impact these changes may have on the ability of contractors to finance the work they must perform under defense contracts. We are also concerned about the ability of the contractors to make investments in capital equipment that will result in more efficient production and thereby lower the total cost of our weapons systems.
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> . . . The Economic Recovery Tax Act of 1981 did a great deal to provide investment incentives to the defense industry and was a move we strongly supported. We believe your current proposal will have the effect of removing those investment incentives and will put the defense industry and other long-term contracting businesses at a productivity disadvantage in relation to other manufacturing firms. At a time when it is vital that defense productivity increase, we don't believe this change is wise.

Treasury's reasons for change.--Treasury's February 26, 1982 Release as it pertains to the reasons behind the CCM proposal is illuminating and deserves comment. First, the CCM is faulted for deferring tax recognition to a later date than is done under "standard [financial] accounting practices," a point that is virtually irrelevant in light of the tax policy that underlies the CCM but has no bearing whatsoever on financial accounting. Secondly, reference is made to "large and unintended tax benefits." In our opinion, the events of 1968-1976 surrounding the rearticulation of tax policy for advance payments and long-term contracts hardly could have yielded anything "unintended." Also, the reference to "tax benefits" is inapposite in the framework of a discussion of whether or not to discontinue nonrecognition of income where the existence of taxable income is not even known.

There follows in the same Release an expression of concern that, because of inflation and the increasing size of new contracts, the deductible costs often will exceed the income to be recognized from old contracts in any one year. This may be true in some instances, but it again is not germane to the issue, which is whether it would be sound policy to recognize and tax receipts or accruals on long-term contracts before the existence of profits can be determined. Nor does the same statement explain why deductions for period costs having no direct causal or beneficial relationship to particular contracts should be delayed until the completion of contracts to which they do not directly relate.

Disparities?—Treasury's explanation of its CCM proposals dwells at some length on presumed disparities as among companies that do and do not use the CCM. The computations are correct, given the facts and assumptions of the examples discussed, but the implication that there is an inequity is misleading. Specifically, taxpayers eligible to use the CCM ordinarily can use either the CCM, the percentage-of-completion method, or an inventory method of accounting, subject to rules of election, consistent application, etc. Each of these options has certain advantages and disadvantages, from both tax and financial accounting standpoints, and the taxpayer makes a conscious choice of accounting method based on individual preferences, exposures, and expectations. Indeed, we could present examples where a taxpayer using percentage-of-completion accounting would be better situated than one using the CCM. Treasury can create illustrations--such as those presented in its general explanation of the

CCM proposals--for any scenario where there is a timing difference with respect to income and/or deductions, but the divergent results at the bottom line in a single case do not alone support an argument for tax revision.

The legislative proposal.--MAPI opposes the legislative proposal to repeal the CCM and require the use of percentage-of-completion accounting or the "progress payments" method. As noted later, we are willing to participate in the resolution of such matters as may need attention in the CCM regulations, but we very definitely disapprove repeal. In addition, we consider the progress payment proposal to be an unsatisfactory substitute for the CCM. As already noted, we do not believe that there should be any recognition of income and costs attributed to long-term contracts until completion where the taxpayer elects such treatment. In contrast, the progress payment method would treat the right to receive an advance or progress payment as being an event with tax significance calling for inclusion in income of the amounts in question offset by allocable costs that are current and previously unclaimed up to the amount of the accrued payment. Payments in excess of attributable costs would be taxed, but attributable costs in excess of payments would be carried forward. Advance payments would be spread over the 12-month period following receipt or accrual for purposes of inclusion in income or in some cases might be entitled to a longer spread upon request and with permission granted.

Little value.--Without wishing to seem intransigent, we find little redeeming value in the progress payment method (PPM). The PPM is a contrivance to augment and expedite the collection of revenues by the federal government, without apparent care for whether or not revenues ought to be gathered. Whereas the CCM since 1918 has allowed taxability to be determined on the basis of a time period equivalent to the contract's duration rather than the arbitrary, annual, accounting period, the PPM would scrap this option. The PPM would appear to be a tax on cash flow and capital itself rather than income; would have a "one way" aspect in that it would impose a tax where accruals exceed attributable costs but withhold recognition to the extent costs exceed accruals; and would interfere considerably with the financing of long-term contracts via loans, advances, and progress payments. An interrelated concern is that period costs would be severely restricted, a subject we will address for convenience in the context of the proposed regulations although they would be covered in the legislation as well.

Complexity.--Relatively little has been said to date about the complexity of the PPM, perhaps because taxpayers have been diverted by the extraordinarily high potential tax cost to them of the proposal. We readily acknowledge that enough accountants equipped with enough computers and calculators could master any system of books and records that is logical, symmetrical, consistent, and complete. By the same token, they would not select a system based on those characteristics alone, without reference to others already in place and such practical aspects as ease of implementation, simplicity of operation and maintenance, comprehensiveness of application, and universality of output. On the positive side of the ledger, we would commend Treasury for its intellectual curiosity in seeking to invent a new method of tax accounting, although we disagree that any new method is needed. On the negative side, we find the PPM to be a peculiar "hybrid" with inconsistent, discontinuous links to at least four methods of accounting--cash, accrual, completed-contract, and percentage-of-completion--the net result of which is to tax work-in-progress based on cash and cost flows unrelated to earnings.

New systems.--A number of taxpayers that have examined the PPM closely and used it to "price out" the Treasury proposal for contracts with advance and progress payments spanning a number of years have remarked that the method is much more difficult to use than any one currently in place or previously available. Under the PPM, cash receipts or accruals virtually take on the significance of sales requiring new recordkeeping for such amounts and for current and previously unclaimed costs. Whereas the CCM is relatively simple to operate and seems understandable to people, the PPM would require fairly elaborate new accounting systems and procedures useful for no purpose but tax reporting, and is not reconcilable with established policy objectives. In deciding whether to act on the PPM or not, we feel that the Committee should inquire not only into the policy but also into the procedural aspects--although the latter admittedly are of less moment--because we understand that unnecessary paperwork burden imposed on the private sector by the government for special purpose reports is anathema to the current Administration and of some concern to the 97th Congress as well.

Financial accounting and non sequiturs.--We wish to reemphasize one point on tax and financial accounting distinctions, because we are aware of some disposition on the part of Treasury to "substantiate" its proposal based on movements in the financial accounting arena to restrict the availability of completed-contract accounting. We refer to Statement of Position (SOP) No. 81-1 of the American Institute of Certified Public Accountants (AICPA) on "Accounting for Construction-type Contracts," and Statement No. 56 of the Financial Accounting Standards Board (FASB) establishing SOP No. 81-1 as "preferable" for changes in method of accounting under Accounting Principles Board (APB) Opinion No. 20. First, any "justification" sought by Treasury from SOP No. 81-1 on behalf of its tax proposal is not pertinent because the tax policy supporting the CCM for tax accounting purposes is not relevant in establishing financial accounting standards. We refer to the principle of withholding taxation until the existence of taxable income is known. The CCM always has been a departure from orthodox accrual accounting for this reason, and ostensibly "supporting" references to financial accounting conventions are not controlling.

Whence Section 462?--We remarked earlier that long-term contracts typically have more risk than other transactions. Rather than extract taxes during the course of performing a contract that ultimately may be a loss, the government, under CCM accounting, waits until the results are known. Now that Treasury proposes to abandon this established policy, we should call attention to the fact that the Internal Revenue Code still does not allow taxpayers to claim deductions for estimated future losses. MAPI and most other interested parties sought this type of reform of the tax laws in 1954 to reflect proper accounting, and the erstwhile Code Section 462 was the result, only to be repealed shortly after enactment because the draftsmen failed to include appropriate safeguards and transitions. The matter was addressed again briefly in the early 1970s only to be shelved, a victim of budgetary priorities. Short of exhuming a complicated issue to add to others already "on the table," we would simply observe that repeal of the CCM would be inequitable in the absence of some other device to mitigate the burden of taxes where the risk of loss is substantial.

The regulatory proposal.--Detailed comments on the regulatory proposal, particularly with respect to costs that would be removed from the existing list of period items, are included in Appendix A to this statement.

Effective date and transition.--It seems obvious to MAPI that any adverse legislative or regulatory changes in the tax law affecting long-term contractors--which changes we do not here support--should thoroughly exclude transactions entered into prior to a date at least six months following enactment and promulgation. Due to the lead time in bidding for such contracts and dramatic cash-flow effects that changes in the tax law and regulations could have, this type of delayed implementation strikes us as the only practical way to lead into a new tax framework without disruption. Furthermore, time would be needed to bring the new accounting "on stream" if only to accommodate systems and software changes, and personnel reorientation. Clearly, taxpayers can take no definitive steps until the policy is established, and there certainly is nothing talismanic or actionable about events that occurred on September 24, 1981 (the President's fall budget message) or February

26, 1982 (the issuance of explanations of the proposals). As with the question of costing, discussed earlier, fairness should be the criterion and not the flow of revenues to the government.

Minimum Tax

Effective January 1, 1983, the current add-on corporate minimum tax would be replaced with a new 15 percent alternative minimum tax on "corporate profits" in excess of $50,000, which would be paid if it exceeded the regular corporate minimum tax. Corporate profits would be calculated by adding back to a corporation's taxable income (excluding net operating loss carryovers or carrybacks) the following series of special deductions, which expand upon the items of tax preference subject to the current minimum tax:

1. Excess percentage depletion.
2. Accelerated depreciation on real property.
3. Amortization of certified pollution control facilities.
4. Amortization of child care facilities.
5. Reserves for losses on bad debts of financial institutions.
6. Intangible drilling costs.
7. Mining exploration and development costs.
8. Lessors' leasing benefits.
9. Deductions for debt to buy or carry tax-exempt securities.
10. Deferred DISC income.
11. Certain shipping income.
12. Amortization of motor carrier operating rights.
13. Excess interest on original issue discount bonds.
14. Deductions for certain costs incurred with respect to long-term contracts.

In general.--To reiterate our position generally, the corporate alternative minimum tax proposal--like the existing corporate add-on minimum tax--is indefensible in principle, and would be an administrative morass. Whereas the change from an add-on to an alternative minimum tax, considered in isolation, would be unobjectionable, the underlying concept of the minimum tax itself is gravely defective and the Administration's proposal would extend and seriously complicate the original policy error. We believe that the corporate and individual minimum taxes should be repealed, and that Congress should deal individually with such "tax preferences" as may seem to deserve review. MAPI has long held this position and documented its views in March 1977 in the pamphlet entitled "The Minimum Tax on Tax Preferences--The Back-Door Route to Federal Tax Increases" and in November 1980 in a commentary entitled "The Minimum Tax on Tax Incentives: A Threat to Capital Formation."

There is a broad spectrum of support for this basic proposition we espouse, including such noted authorities on taxation as Professor Boris I. Bittker of Yale University Law School who testified in pertinent part before the House Committee on Ways and Means on June 23, 1975, as follows:

> "I want to address myself this morning, and I will do this briefly, to a fundamental question that I think your committee must cope with. That is whether in approaching your task you would do well to focus on tax provisions individually on their merits retaining those that seem worthy, repealing those for which a good case cannot be made, modifying, limiting, expanding, and so on, others as that seems appropriate; or whether instead the committee should continue along the tendency which has become evermore apparent in the last few years of moving to such roundabout, as I would see them, approaches

to tax reform as the minimum tax, the proposed limit on artificial accounting losses, and the proposed allocation of permanent deductions between taxable and exempt income.

I would like to urge the committee to do the former, to bite the bullet of tackling statutory provisions head on making the judgment and then standing by the judgment as to whether provisions considered on their merits are worthy, should be repealed, should be expanded, or modified, and so on.

First, a comment on the minimum tax which was enacted in 1969. In my view, this approach to the area is going to lead and indeed to some extent has already led to an open-ended endless process of tinkering with very little positive advantages, and some serious disadvantages.

You have already faced, and I am sure if you continue on this road, will face again and again in the future the question of whether a minimum tax should be an alternate tax to be paid instead of the regular tax under specified circumstance, or a supplemental tax, or auxiliary tax to be paid in addition to the regular tax.

You will have constantly before you questions of the exemption level for the minimum tax in whatever form it may be adopted. You will have the rate question. You will have above all an endless series of questions about the items to be included as tax preferences or tax allowances, or whatever the label may be, because it is perfectly clear to me, and I think clear to all that there are bound to be a series of distinctions or compromises between a wholly comprehensive concept of economic income which as has been suggested before would include net worth changes, and a singling out of particular items, particular tax provisions for inclusion in the economic income base.

In other words, economic income it seems to me is almost certain to be itself a series of compromises, and I think this committee will find the making of those compromises a never-ending process, and in the meantime it is my view that the basic provisions themselves will tend to be neglected on the theory that whatever defects they may have will be adequately taken care of through the minimum tax, and indeed there may be an invitation, an implicit invitation to expand the basic provisions in a way which miraculously Mr. Surrey and Mr. Smith agreed was undesirable on the theory that, no matter what you throw into the Code, the minimum tax will make up for the defects of that decision.

> Then finally with respect to the minimum tax, it seems to me its fundamental concept is open to serious objection. What I mean is this: That if for some reason the committee and the Congress determined that a particular tax allowance, let us say, for low-cost housing, or whatever it may be, is desirable, I find it difficult to understand why one should then nibble around the edges with a minimum tax. If a particular housing project for example is to be encouraged, or housing is to be encouraged through this tax allowance that I have just suggested, why should it make a difference that "A" invests a great deal in that project and helps to get it built and gets the deductions which are implicit in that project, or "X", "Y", and "Z", enter into the project as partners and divvy up the tax allowances among them in a way that escapes the minimum tax?
>
> In other words, once your decision has been made to adopt the allowance because you see a social objective or an economic objective that is to be achieved, it seems to me that you ought to be prepared to accept the responsibility that that allowance is going to be availed of by persons who wish to invest or move into that activity and, as I say, I find it difficult to understand why assuming the objective is desirable it should make a difference that one person moves into it very heavily, or a group of people move into it on a more restrained scale."/1

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Understatement.--To describe the minimum tax as a "roundabout" approach to tax reform is to engage in understatement. The Congress enacted certain tax incentives because it found they were economically or socially desirable, and then it imposed a minimum tax on the incentive element to dampen its effect. This is policy in a state of confusion--a point to which we will return--and we are no more sanguine about the device after 13 years of exposure to it than we were in 1969 when it was enacted. Although an alternative minimum tax comports more nearly with the "fair share" rationale for the levy than does the add-on variety,

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1/ "Tax Reform Hearings," June 23-25, 1975, Committee on Ways and Means, U.S. House of Representatives, 94th Congress, 1st Session, Committee Print, pp. 73-76.

the allegations of runaway overindulgence in tax preferences by wealthy taxpayers has not held up well under close scrutiny, and the tax never will prevent avoidance by those so inclined in any event. Meanwhile, it is an unwelcome complication of a federal income tax law that already is too complex, and, to aggravate matters, the tax undermines legislation that was enacted to reduce tax disincentives to capital formation. The minimum tax is "scattershot" policy with the appearance of an abdication of responsibility it obfuscates legislative intent as to the handling of specific issues; and it, therefore, should be repealed.

Confusion.--Returning to "confusion" as it relates to the proposals, we can assure the Committee that the management and planning of corporate affairs is not facilitated by uncertainties with respect to tax burden. The minimum tax proposal would introduce a new element of uncertainty because corporate taxpayers--especially in capital-intensive, cyclical industries--often could not know with any degree of assurance whether and in what amount they would incur the alternative levy. Similarly, the possibility of encountering the minimum tax would always leave doubts as to the "benefit" to be expected from tax preferences otherwise routinely available to corporations in their operations. Whereas Treasury has given the impression that it wishes to tax corporations that pay little or no federal income tax while reporting large profits to their shareholders, the proposal bears no relation to income reported to shareholders and would affect many corporations with low, or nonexistent, regular, corporate income taxes even when there are book losses as well. This would be a strange--in some respects, ominous--

turn of events, wherein minimum taxes would be extracted in years of difficulty (an untimely burden) and credited back against regular taxes payable in years of recovery (an untimely benefit).

Investment tax credit.--Another especially bothersome aspect of this proposal stems from our understanding that some 50 percent of the estimated revenue "take" from this proposal would be due to the deferral of investment tax credits (ITCs) because no credits other than the foreign tax credit would be allowed to offset the minimum tax. For example, consider a corporation "A" under existing corporate tax law with taxable income of $1 million: Assuming for simplicity a rate of 46 percent, the regular tax before credits would be $460,000. Assuming ample ITCs, up to 90 percent of the regular tax, or $414,000, would be offset by credits, leaving a tax payment of $46,000. Now hypothesize a corporation "B" under the proposed law with "corporate profits" in excess of $50,000 (i.e., the minimum tax base) amounting to $1 million; a 15 percent alternative minimum tax of $150,000 due and payable because (we will assume) it exceeds the regular tax; and sizable carryforward ITCs. This corporation "B" would have to defer its ITCs until a future year when the regular corporate income tax exceeds the minimum tax. Depending on the length of the deferral, the value of the ITCs could dwindle to nothing. MAPI objects to this "back door" attack on ITCs, and we cite it as but one of several shortcomings of a proposal that should be scrapped.

A minimum tax on no tax preferences?--We note also--from Examples 2 and 3 of Treasury's general explanation of the proposal--

that the alternative minimum tax could apply to a corporation with none of the listed tax preferences. Consider corporation "A" in the previous example with $1 million of taxable income, $460,000 of tax before credits, $414,000 of credits, and a $46,000 regular tax payment under ordinary computations. This same company's "corporate profits" in excess of $50,000 would be $950,000 (i.e., $1 million of taxable income plus zero "special deductions" minus $50,000). The alternative minimum tax would be 15 percent of this amount or $142,500. Inasmuch as the alternative minimum tax would exceed the regular corporate income tax, the former would be due and payable, with a minimum-tax credit of $96,500 ($142,500 minus $46,000) to be carried over as a credit against the regular tax in the next year's computation. This objectionable and unprecedented aspect of the proposal would resurrect the concept of "economic income," and saddle corporate taxpayers with a minimum tax of 15 percent on taxable income regardless of the circumstances.

Preferences.--As to the proposed new preferences, we note that a recent Congressional Budget Office (CBO) report identified the existence of some 104 categories of "tax expenditures" as being in existence for fiscal year 1982./1 We assume that Treasury selected the new items in its list in order to curtail the cost of some preferences thought to be less efficient than others; to try to reduce controversial preferences; and/or simply to settle on ones with limited political exposure for the Administration. Short of traversing the entire list, we will direct our

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1/ "Tax Expenditures: Current Issues and Five-Year Budget Projections for Fiscal Years 1982-1986," CBO, September 1981.

comments to deferred income of Domestic International Sales Corporations (DISC), with the intent that similar views could be addressed to most of the others. We stated earlier that tax incentives should not be reduced through the "back door" approach of a minimum tax but instead should be considered on their individual merits. DISC exemplifies this because the enactment or removal of an export tax incentive should be decided with reference to the international trade environment, including tax treaties, bilateral and multilateral trade pacts (where applicable), nontariff barriers to trade, and other U.S. and foreign export policy. The future of DISC benefits should not be a function of "fair share" rhetoric having nothing to do with the subject matter.

Summation.--To conclude on the minimum tax proposal, we see some usefulness to changing the corporate minimum tax--if there is not to be outright repeal--from an add-on mode that layers one tax indiscriminately atop of another to an alternative mode. However, we object to lengthening the list of preferences and having the tax operate where there is no preference income at all. Also, we urge the Committee not to allow any such tax to reduce the value of investment credits.

By any objective analysis, the minimum tax is a blunt, dull, mischievous, and just-plain-poor instrument of tax policy, and in our opinion, should be stricken from the statute books.

Reservations Expressed About Elimination of Tax-Exempt Financing for So-Called Private Activities (Industrial Development Bonds)

Treasury's proposal would limit tax exemption for "private purpose" obligations currently eligible under Code Section 103 to those issued under the following conditions:

1. The bonds must be approved by the highest elected official or legislative body of the governmental unit, or by a voter referendum.
2. For bonds issued after 1985, the governmental unit would have to make a commitment to the facility being financed equivalent to 1 percent of the face amount of the bonds on the date of issue, or designate the bonds as general obligations.
3. Depreciable assets financed with tax-exempt bonds would be subject to straight-line depreciation over the recovery period used for earnings and profits (E&P) computations.
4. Exempt "small issue" IDBs would be limited to "small businesses," as defined. A small business would be one with capital expenditures of less than $20 million over a six-year period and not more than $10 million of IDBs outstanding after issuance.
5. Within the restrictions of items 1. through 4., above, small-issue IDBs could be sold as a part of an umbrella issue of bonds.
6. Each bond would have to be in registered form and information concerning the issuance of the obligations would have to be reported by the state or local government to IRS.
7. Restrictions on the investment yield from the use of bond proceeds would be extended to reserve funds and funds held

during the temporary construction period. Bond costs could not be taken into account in determining the arbitrage yield limitations.

8. Except as indicated above with respect to the financial commitment rule, item 2., the additional restrictions generally would apply to private purpose bonds issued after December 31, 1982. However, the restrictions would not apply to single-family mortgage subsidy bonds issued before January 1, 1984, because those bonds would be denied exempt status after 1983.

General observation.--As set forth earlier, we do not take exception at this time to the proposals for public approval; for a commitment by the sponsoring governmental unit; for registration and information reporting; or for increased arbitrage limitations--provided that each of the foregoing conforms to standards of fairness and administrability. We adopt this posture partly in response to Treasury's rhetorical characterization of IDBs as "private purpose" bonds. Although the bonds in question depend on the credit of private entities rather than that of governmental bodies, the federal income tax exemption for interest earned on such obligations has existed in the tax law since at least the early 1930s. The exemption is ascribable to the fact that state and local governmental units and previous Congresses have felt that "public" benefits are derived from facilities financed by IDBs, whether they are industrial plants attracted to areas deemed by state and local development authorities to need economic development or such facilities as convention halls, airports, sewage disposal plants, or pollution control apparatus. We do not object to such further reasonable procedures as may be needed to ensure that municipalities consider IDB-financed facilities to have sufficient "public" interest to enjoy the benefits of exempt financing.

Conflicting objectives.--By the same token, we believe that if there are adequate safeguards of the "public" interest in so-called "private" facilities to be financed by IDBs, then it is senseless to superimpose on the IDB-financing process added requirements, such as straight-line depreciation over extended recovery periods, that drain off the benefits of exempt financing and render it an exercise in futility. Also, there is a curious and possibly irreconcilable conflict of objectives here because the Administration elsewhere proposes in its "new federalism" initiative to yield a portion of the federal tax base to the states in order to decentralize the responsibility for certain programs and, additionally, would establish "enterprise zones" with special tax benefits not unlike the practice of state and local development authorities in offering IDB financing for certain investments in selected areas. If decentralization of decision making and economic development through federal tax abatements are objectives of the Administration, then there would seem to be some merit in continuing to use a mechanism that has been in place for the last half century.

Unintended beneficiaries.--As to the criticism sometimes leveled at IDB-financing concerning occasional, infrequent "off beat" uses or unintended beneficiaries, we do not accept de facto repeal as an appropriate remedy any more than we would prescribe amputation to deal with a superficial wound. The newly proposed public clearance and commitment procedures would minimize these isolated occurrences, and we do not think that other constraints would be necessary or warranted. There has been some occasional discussion of restricting "small issue" IDBs to "industrial" development--from whence this form of financing takes its name--by some definition, as distinguished from "commercial" activity. As an organization mainly representing industrial enterprises, MAPI does not object in principle to this proposal. On the other hand, we could foresee difficulties in establishing and then administering such a distinction, and to do so would remove an element of choice from the decision on exempt financing that perhaps should be left at the local level. If the Committee nonetheless feels that new "small issue" IDB restrictions should be imposed, we would be less opposed to this definitional restraint than to the debilitating proposals for straight-line depreciation.

"Small" versus "large" companies.--Further concerning "small issue" IDBs, we strongly object to Treasury's proposed differentiation between "small" and "large" companies for purposes of eligibility. The federal income tax law should not discriminate in this way where there is no compelling policy rationale for treating similar situations differently. In asserting that large companies can finance their operations without resort to IDBs, Treasury seems to us to miss the point. The question is not whether some category of companies can "afford" conventional--as compared to exempt--financing in an abstract sense. Rather, the question is whether a particular investment will or will not be made by any enterprise in a particular locality without the marginal reduction in anticipated costs derived from exempt financing. It stands to reason that more capital spending will be justifiable with exempt financing than otherwise--all other factors equal--and that projects considered uneconomic with conventional financing will not be undertaken by rational decision makers in any enterprise. The only practical effect of limiting "small issue" IDBs to "small" businesses would be to force the curtailment of some capital spending plans that normally would be approved.

Propriety of Further Speed-up in Corporate Tax Payments Is Questionable

Treasury's proposal to speed up corporate tax payments has three parts, as follows:

1. Required estimated tax payments would be increased from 80 percent to 90 percent of current year liability.
2. All remaining liability would have to be paid on the 15th day of the third month following the close of the tax year rather than half on the 15th day of the third month and half on the 15th day of the sixth month.
3. For large corporations (those with over $1 million of taxable income in any of the three preceding years) which base their estimated tax payments on the prior year income or liability, the minimum required payment would be 85 percent of current year liability in 1985 and 90 percent in 1986 and thereafter.

The first two proposals would be effective for tax years beginning after December 31, 1982. The third proposal would be effective for tax years beginning after December 31, 1984.

The float.--We do not feel that this speed-up of payments should be pursued because corporate taxpayers, like others, are unable to estimate their tax liabilities accurately prior to year-end and, even then, need the additional time currently allowed in which to gather information and carry out computations for that purpose. Also, the third proposal frankly strikes us as presumptuous in the wake of law enacted six months ago to raise the minimum percentage to 80 percent over a three-year transition period. We acknowledge that Treasury never will yield in its attempts to squeeze the "float" out of tax payments, but we also know--as, we suspect, does Treasury--that unrealistic requirements for the amount and timing of tax payments can only have the effect of compelling overpayment to avoid penalties. Treasury already is "stretching the fabric" more than it should with its "cash management" initiatives, and we advise against any further undue pressure on taxpayers and withholding agents. In a nutshell, the Treasury Department has not made its case and the new proposal represents overreaching. It should be rejected.

Perspective.--To put our opposition in perspective, we should point out that most corporate tax payments come from entities that are multi-establishment, multi-division, multistate, and/or multinational enterprises. In organizations such as these--and perhaps even in "mom and pop" stores, although the circumstances would be different--uncertainties as to the total amount of current-year liability continue well beyond year-end, which accounts for the fact that remaining liability now can be paid in two installments and corporate returns often are filed with allowable extensions on the 15th day of the ninth month after year-end. We emphasize that there are few, if any, parallels that can be drawn between the circumstances of corporations such as these and individuals with respect to their abilities to estimate and pay tax liabilities promptly after the close of their annual fiscal periods. Also, Treasury's assertion that corporations can estimate their income "on a monthly basis"--impliedly with accuracy--simply is misleading.

Some facts.--It is not true that corporations can estimate their taxable income with accuracy on a monthly basis, and any reference to book income in this context is not germane. Estimated tax payments are based on a host of projections backed by a myriad of assumptions, and they are particularly uncertain early in the year. Even as the year progresses, changes in capital spending plans, fixed asset dispositions, and other departures from earlier projections can alter the outlook as it relates to final tax liability. Let us add that management changes-of-direction having a direct bearing on tax liability for the year are often made without any reference at all to the tax incidents. Contrary to Treasury's assertion, for many corporations the "remaining payments" on March 15 and June 15 (assuming calendar year companies) are educated guesses because of organizational complexity, geographical diversity, and the mechanics of assembling data and preparing returns.

Other considerations.--We urge the Committee to recognize that a corporation, especially a multi-establishment one with international operations, needs time to compute its tax liability accurately. This also helps to minimize problems arising on audit, hopefully a benefit to IRS as well as the corporate taxpayer. It may be of some interest to the Committee members to know that tax management personnel of corporations often personally visit major reporting locations after year-end to review planned submissions and try to avert errors that otherwise would require extra attention on audit at a later date. Clearly, the time frame cannot fairly be compressed in the way that Treasury has proposed.

Finally, Treasury indulges in excess when it proposes still higher percentages for estimated taxes based on the prior year's liability. Had Congress wished to make such a change when it enacted ERTA six months ago and boosted the number to 80 percent, Congress would have done so at that time.

To conclude on this subject, we have been advised by some of our member companies that the cash management changes alone would negate all of the cash flow benefits they derived from ERTA.

Congress Should Reject Treasury Recommendations on Interest and Dividend Withholding

As outlined by Treasury, a flat rate tax of 5 percent would be withheld from interest and dividend payments made to individuals in generally the same manner that tax currently is withheld on wages. Corporations and nontaxable individuals filing exemption certificates would be exempt from withholding. Taxpayers age 65 or older with tax liability of $500 ($1,000 on a joint return) or less also would be exempt from withholding. The proposal covers all payments of taxable dividends and interest that now are subject to information reporting, as well as payments on other obligations of a type generally offered to the public. Interest paid by individuals would not be subject to withholding. The proposal would extend withholding to include payments without a threshold dollar amount. Payees would attach copies of revised Forms 1099 showing income and withheld amounts to their tax returns, and they could adjust estimated tax payments and wage withholding to avoid overwithholding.

Individuals would not be allowed partial exemptions from withholding for the $100/$200 dividend exclusion, or for the 15 percent net interest exclusion effective after 1984. However, no withholding would be required on interest paid on All Saver's Certificates, dividends reinvested in public utilities' stock pursuant to a qualified Dividend Reinvestment Plan, or interest paid on tax-exempt state and local bonds.

Opposition.--MAPI considers this proposal to be the most thoroughly shopworn item in Treasury's inventory of proposed tax revisions. Although interest was made subject to withholding--along with certain other kinds of income not including dividends--by the Tariff Act of 1913, all withholding other than for some payments to foreigners was repealed in 1917 in favor of information reporting and not reinstated for wages until the Revenue Act of 1942 and Current Tax Payment Act of 1943. Thereafter, the subject of withholding on dividends and interest has arisen with enough frequency to fill the public record with very substantial evidence in opposition. The Committee will recognize that this opposition is not offered without realization that there is some "leakage" in tax collection from dividends and interest. Nor, we might add, do the opposing parties always represent types of payors who would be unduly burdened by the proposals. The "flaw" in the idea is that the total estimated costs do not seem to have a reasonable relationship to the anticipated benefits.

Costs and benefits.--In referring to the total costs, we include the paperwork burden of payors and taxpayers (including the elderly); reduced cash flow to dividend and interest recipients, depending on the design and use of exemption procedures; complications associated with the withholding exemption procedures; questions of definition and coverage as to dividends and interest; new regulations to cover withholding procedures for many differing types of payors and financial instruments; identifying and segregating "covered" versus exempt persons; the failure or inability to take account of the dividend or net interest exclusions; and perhaps others. We cannot see that it would be useful to complicate the tax law and the affairs of so many parties for the sake of gaining a better timing of revenue flows to the government and a moderately improved compliance experience. If the current information reporting is not as comprehensive as Treasury would like, then perhaps it should be expanded. Indeed, IRS has stated publicly that the information reporting program is increasingly successful, and is achieving ever-higher percentages of successful document-matching. We still believe that this is the least-obtrusive approach to dealing with the taxation of interest and dividends.

In connection with the choice between extension of mandatory withholding and improvement in the information reporting system, attention should be called to the proposed bill, "Taxpayer Compliance Improvement Act of 1982" (S. 2198), introduced by Chairman Dole.

Taxpayer burden.--Whenever government raises this subject, it extols the fairness of its proposal because of exemption procedures, including withholding exemption certificate procedures. At the same time, government surmises that such revenues as it may be losing may be largely attributable to inadvertence on the part of low-income taxpayers who cannot economically be pursued by IRS on audit. We do not know whether this is the case or not, but marginal taxpayers receiving interest and dividend payments would seem to us to be the ones for whom exemption procedures would be most necessary. Yet low-income individuals--including the elderly--are the persons most oppressed by the complexities of the existing tax apparatus, and they would find the exemption procedures difficult to use. In imposing withholding, Congress would, in our opinion, put many persons who would qualify for exemption in a position of overpaying their taxes, because they could not or simply would not avail themselves of the exemption arrangement. Just as government finds it cost-ineffective to pursue small accounts, so too would payors and many marginal taxpayers find it onerous to live with these new procedures.

Information reporting.--Inasmuch as the Committee will be hearing much more about this from payors and dividend and interest recipients, we will conclude our remarks by recommending that the withholding proposal be dropped. It is an idea whose time has not come, and information reporting still is the way to go.

* * *

MAPI takes no position at this time on other proposed tax revisions of the Administration, including such matters as modified coinsurance; increases in Internal Revenue Service (IRS) personnel; enterprise zones; user taxes; passport and visa fees; changes in the railroad retirement system; the highway trust fund taxes; hospital insurance taxes for federal civilian employees; and the "new federalism" proposal.

The Institute appreciates having the opportunity to appear before the distinguished Senate Committee on Finance to present views with respect to the tax proposals in the Administration's budget.

APPENDIX A

MAPI Statement to the
Senate Committee on Finance
March 19, 1982

Detailed Comments on the Regulatory Proposal Affecting Completed-Contract Method Accounting

Treasury is of the view that more indirect costs, now allowed under Regs. 1.451-3(d)(iii) to be treated as period items deductible when incurred, should instead be attributed to contracts and matched against income at the time of contract completion. The proposed cost requirements would be the same for long-term contracts whether accounted for by the CCM, an inventory method, or the PPM. The costs that would be removed from the existing list of period items appear to be the following:

1. Marketing, selling, and advertising expenses that bear some undefined relationship to contracts.
2. Bidding expenses incurred in the solicitation of contracts awarded to the taxpayer.
3. "Other distribution expenses."
4. Interest.
5. General and administrative (G&A) expenses attributable to the performance of services that benefit the long-term contractor's activities as a whole.
6. Research and experimental (R&E) expenses that are directly attributable to particular contracts in existence at the time such expenses are incurred or incurred under any agreement to perform such R&E.

7. Percentage depletion in excess of cost depletion.
8. Depreciation and amortization (other than for idle equipment and facilities) reported for federal income tax purposes in excess of that reported for financial purposes.
9. Pension and profit-sharing contributions representing current service costs otherwise deductible under Section 404, and other employee benefits incurred on behalf of labor.
10. Costs attributable to rework labor, scrap, and spoilage.
11. Compensation paid to officers attributable to the performance of services which benefit the long-term contractor's activities as a whole.

Tampering.--Treasury would tamper here with most period costs allowed by the existing regulations, and reduce the list of eligible items in a manner that is arbitrary. Evidently, the government has been attracted to a concept of "full absorption" wherein almost every expenditure of an enterprise is allocated to a contract or product whether accounting conventions exist to support delayed cost recognition or not. We sense that Treasury is following a "rule of convenience" under which accounting orthodoxy is cited where it conforms to a preconceived notion about revenue collection but is eschewed where it is not conducive to the desired result. We have critical comments with respect to several of the cost categories that Treasury would attribute to contracts, because we do not agree that they were classified improperly by Treasury Decision 7397 of January 14, 1976. For present purposes, we will mention only several of the cost classifications, inasmuch as we oppose the PPM legislation generally and expect to have the opportunity to comment at length on the same matter in the regulatory proceeding.

Marketing.--First, we anticipate that there would be increased administrative burden and endless disagreement in deciding whether marketing, selling, and advertising expenses are attributable to particular contracts. For example, marketing personnel incur costs constantly, often without knowing whether, when, or to what extent their efforts will yield contracts of any duration, long-term or short-term, and the cost accounting systems of enterprises normally do not make such discriminations. Because of the nature and purpose of these and many other indirect costs, reasonable minds would disagree on the questions of amount and attribution. Along the same lines, most companies do not now treat any of these amounts as contract or product costs, and a number frankly have described the proposed reclassifications as "unworkable." As to bidding expenses, large expenditures can be made in this area over a span of months or years with no reason to know at the time of cost incurrence whether a contract will result or not. We question the propriety of delaying recognition as to any of these amounts until contract award. Also, because of the uncertainty that they will ever give rise to income, we believe that all such costs should be deductible as incurred.

G&A.--Concerning G&A that benefits all activities, including officers' compensation, the absence of a direct causal or beneficial relationship is the very reason why period costing should be permitted.

One may argue that nearly every cost has some relationship--however tenuous--to a contract, product, or service, but proper accounting does not contemplate a delayed recognition of overhead expenses incurred for the business as a whole. Contrary to Treasury's proposal, there is a point beyond which "fuller" cost absorption in inventories or contracts is poor accounting for tax as well as financial purposes and does not yield a clear reflection of income pursuant to Code Section 446. We doubt that financial reports prepared in accordance with the proposals would be approved by independent accountants because of the heavy indirect cost deferrals, and the accountants' judgment regarding "clear reflection" on this score would be no less appropriate for tax than for financial purposes. Sound accounting is not a function of how quickly the government collects revenues.

Interest.--To continue, "interest" is a cost of financing, and has been acknowledged to be a period cost for almost as long as double-entry bookkeeping has existed. Efforts to trace the cost to a cost objective, in view of the fungibility of money, are likely to be awkward or arbitrary, and there are few instances where capitalization of interest has been ruled appropriate or tracing has been attempted. One of these instances is FASB Statement No. 34, which has attracted criticism from many industrial accountants who think it preferable to expense all interest for financial as well as tax accounting purposes. Another aberration would be the provisions of Regs. 1.861-8--also controversial--which attempt to allocate and apportion certain U.S.-source interest against foreign-source income for foreign tax credit limitation purposes.

The Committee also will recall that Code Section 163 treats interest as a deduction, and may wish to consider whether a contract-attribution approach to interest would compromise that policy. Finally, we would point out that interest on operating capital is not an allowable expense for cost reimbursement in defense procurement, and that delayed tax recognition would aggravate this inequity.

Depreciation.--Without covering each of the costs that would be shifted by Treasury, we will conclude for now on depreciation and amortization reported for tax purposes that is in excess of such amounts per books. In attributing this amount to a long-term contract and delaying recognition, Treasury would nullify to an extent the tax benefits just conferred by Congress in the Accelerated Cost Recovery System (ACRS). This type of equivocation and contradiction in tax policy is disturbing and reinforces the conclusion sometimes drawn in the private sector that federal income tax policy--including so-called "incentives" given with one hand and taken away by the other--are too unreliable to incorporate in decision making. We disagree with the Treasury proposal and deal with this same subject in connection with the corporate alternative minimum tax.

Change-orders.--Moving to other regulatory proposals, we note that Regs. 1.451-3(e) would be amended in several ways, one of which would specify that if an agreement is amended (as by the exercise of an option or the issuance of a "change order") to increase the number of items to be supplied under the agreement, such modifications shall be treated as a separate contract or as several separate contracts. As indicated earlier, we have no quarrel with reasonable rules of "severability" and "completion," and feel that the question should be settled by such regulatory amendment as may be warranted toward that end. Although we were unaware of flaws in the existing rules, we agree that contracts should not remain "open" indefinitely. As to the proposal just mentioned, options-to-extend and change-orders are quite different because the latter can significantly alter the economics of transactions, with the result that severability requirements in that context should not be rigid. Also, we do not agree that a contract should be considered "complete" without regard to any obligation of the contractor to supervise installation or assembly if final acceptance is dependent upon such actions and demonstrations of performance in accordance with specifications.

Senator CHAFEE. Senator Symms.

Senator SYMMS. Thank you very much, Mr. Chairman. Thank you, Mr. Stewart, for your statement. I have no questions, Mr. Chairman.

Senator CHAFEE. Thank you very much, Mr. Stewart. We will read over your testimony and appreciate your coming a great deal.

Mr. STEWART. Thank you.

Senator CHAFEE. Now the next panel is all set to go. But Senator Dole wanted to be here. He had some major interest in that panel, so we will take that panel after the last. The last shall be first.

Mr. Perlman, Mr. Cherecwich, and Mr. Christrup. So, gentlemen, if you will come up. And this panel has 20 minutes.

STATEMENT OF ROBERT PERLMAN, SEMICONDUCTOR INDUSTRY ASSOCIATION, WASHINGTON, D.C.

Mr. PERLMAN. Thank you, Mr. Chairman. My name is Robert Perlman. I'm tax director of Intel Corp., headquartered in Santa Clara, Calif.

Senator CHAFEE. Is Mr. Christrup missing? He doesn't say he is missing. He must be missing. [Laughter.]

All right. Go ahead, Mr. Perlman.

Mr. PERLMAN. Intel is an independent semiconductor manufacturing company with annual sales currently of $800 million per year. I appear before you today representing the 55 companies of the Semiconductor Industry Association.

The U.S. Semiconductor Industry, the world leader in technology and market share, is under severe pressure from the current recession and from foreign competition. During 1981, revenues decreased slightly and profits were down dramatically. However, the industry must continue to invest in R. & D. and in new equipment at a record pace. Otherwise, the U.S. manufacturers could be caught without the technology or capacity to deliver products which will be demanded when world economies recover. The world environment today reflects the views of many countries that high technology should be developed internally for export. This view reflects the goals of the U.S. industry, and hopefully, the U.S. Government. The goals I refer to are: One, perform R. & D. in the United States; two, maintain U.S. leadership in high technology; three, export manufactured products; and four, whenever feasible, create jobs in the United States.

The present tax laws reflect these goals, and enable U.S. semiconductor manufacturers to compete. We believe any new tax proposals, in particular the proposed alternative corporate minimum tax, should be considered in light of these goals. It is crucial in considering revenue raising proposals that the tax laws do not make it impossible or unduly difficult for us to operate effectively within the United States. We think it important to comment on five suggested items which would increase revenues through the minimum tax.

First: R. & D. expenditures. If R. & D. expenditures are to be amortized rather than expended or if the R. & D. credit is not allowed against the minimum tax, the message transmitted is "Do Your Research Elsewhere." Other countries would be overjoyed at this result. Any adverse effect on the treatment of R. & D. can only impair international competitive positions.

Second: Equipment investment. If some preference for ACRS deductions is necessary, the preference must at least permit high technology companies to depreciate their equipment over actual useful lives—3 or 4 years. If depreciation is permitted only over some longer period, such as 8 years, or if the investment tax credit is not allowed against the minimum tax, the message would be to manufacture elsewhere so that the cost of equipment could be recovered more rapidly. And the funds available to replace the equipment at the end of its economic life.

Third: The foreign tax credit. If foreign taxes are not allowed as a credit against the minimum tax, the result would be double taxation, the very thing the foreign tax credit exists to prevent. My company repatriates virtually all its overseas sales profits, notwithstanding the present difficulties in obtaining a full credit. If no foreign tax credit is permitted against the minimum tax, it would then be beneficial to invest these profit overseas rather than repatriate them to pay for U.S. plant and equipment.

Fourth: DISC. The deferral of DISC income has been suggested as a preference item. If this income is included a valuable stimulus of export might be removed, making U.S. industry less competitive in the international arena.

Finally: Possessions corporations. If the earnings of possessions corporations are subjected to a tax in the United States, the competitive advantage of that part of the United States will fall substantially in comparison to Southeast Asia or Latin America. Plans for additional plant capacity within Puerto Rico would be disadvantaged.

Gentlemen, we operate in a very volatile marketplace, one that other governments have targeted as one they wish to dominate. Semiconductor companies for the most part pay little or no dividends and utilize their profits for research, plant capacity, and increasing overseas market share. In order to plan in such an environment, it is essential that the U.S. Government recognize that other governments offer substantial tax incentives, that the United States itself must offer a reasonable level of tax incentives, and that the ground rules of these tax incentives should not change every year. We must be able to plan with some level of reasonable certainty.

We do not oppose all tax increases or even all increases that affect our industry. Instead, we stress to you the effects and the likely results on our industry of certain proposed legislation. And we urge you to allow us to manage our business in a stable environment, free from frequent reversals in tax policy and in a manner consistent with the common goals of our members companies and the United States.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF ROBERT PERLMAN

Good morning, Mr. Chairman. My name is Robert Perlman. I am Tax Director of Intel Corporation, headquartered in Santa Clara, California. Intel is an independent semiconductor manufacturing company with annual sales currently of $800 million per year.

I appear before you today representing the 55 companies of the Semiconductor Industry Association (SIA).

Our purpose today is to describe for you the effect of the Administration's tax proposals, and other tax proposals pending before you, on the U.S. semiconductor industry and on the ability of U.S. semiconductor companies -- and other U.S. high technology companies -- to compete in international markets. But first I would like to take a moment to describe for you the current state of the U.S. semiconductor industry.

The U.S. Semiconductor Industry

The U.S. semiconductor industry has been the world leader in semiconductor products both in terms of technology and market share. However, the current recession in the United States has seriously eroded the sales and, in particular, the profitability of these U.S. companies. This comes at a time when the position of the U.S. industry is already under a severe challenge from Japan and to a lesser extent from the Western European nations.

Despite the current recession in the United States and elsewhere, the worldwide semiconductor industry is expected to undergo explosive growth during the 1980's not only in sheer volume but also in the diversity of market applications. In 1980, world consumption of semiconductors reached $16.1 billion including both unrelated and related party uses. The world semiconductor industry supports approximately a $200 billion electronics equipment market. Industry analysts predict that the world semiconductor volume will reach or surpass $50 billion before the end of this decade and will support a world equipment market of over $500 billion. */

The U.S. semiconductor industry in 1980 accounted for 63 percent of world consumption, compared to 22 percent for the Japanese industry, and 12 percent for the European industry. By 1982, however, international competition has become much more evenly matched than 1980 overall market share data would indicate. The Japanese, who only began to export integrated circuits to the United States in volume in the mid-1970's, have achieved significant market shares in the United States for a whole array of advanced large scale integrated circuits (LSI) products. Currently Japanese industry holds 42 percent of the 16K dynamic RAM (random access memory) market and over 70 percent of the 64K

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*/ The semiconductor industry with advancing technology will account for a continued increase in percentage of equipment value from 8 percent in 1980 to 10 percent by the late 1980's.

dynamic RAM market. Furthermore, at a recent technical conference in San Francisco, all five technical papers on the 256K RAM, which will probably be the workhorse memory circuit of the late 1980's, were Japanese. These large memory circuits are the "flagships" of semiconductor technology. Moreover, because they are growing at over three times the rate of all semiconductors, sustained leadership in these commodity products will mean long-term market leadership.

In 1980, virtually 50 percent of the worldwide semiconductor volume was consumed outside the United States. In the quarter century history of the industry, the U.S. merchant industry has fiercely competed in all markets worldwide and currently sells 35 percent of its production outside the United States; if historical trends were to continue, there is reason to believe that within 10 to 15 years, 45 percent to 50 percent of U.S. company sales would be in international markets.

Success in worldwide competition is determined by a company's innovation rate and the advancement of technological complexity. As recently as 1970, the semiconductor industry was producing memory circuits containing 1,000 elements of memory. At present, the industry is commencing production of a dynamic RAM with 64,000 elements on a chip, and by 1989, industry sources speculate that the most advanced chips will contain over 1,000,000 elements.

These high levels of growth and increasing complexity cause dramatic increases in the requirements of U.S. semiconductor companies for new capital. The U.S. semiconductor industry's investment in short-lived process equipment and in R&D is now 28 percent of sales, compared to the U.S. industry average of 7 percent of sales. To finance this investment the industry must constantly generate fresh capital. Indeed, the industry's principal challenge is the availability and cost of its capital.

This is not a problem shared equally by the major foreign producers of semiconductors. American companies have a significantly higher cost of capital than the Japanese semiconductor manufacturers, and potentially the Europeans as well, with whom they must compete. A 1980 study prepared by Chase Financial Policy, a Chase Manhattan Bank subsidiary, revealed that the cost of capital for the typical American semiconductor company averages 17.5 percent, compared to only 9.3 percent for the Japanese competition. The study also revealed that, although American firms are compelled to earn a rate of return approximately equal to the cost of capital, currently 16.3 percent on operating capital, the Japanese companies fall short of covering capital costs with a return of only 7.5 percent.

In the long term, this structural advantage -- lower cost of capital and current profit indifference -- will work to the distinct disadvantage of American firms, jeopardizing their ability to earn sufficient return to cover capital cost and therefore their ability to compete.

Yet, the support of Japan and other countries for their semiconductor and computer industries goes beyond the relative cost of capital. It includes direct subsidies, research tax incentives and cartels, a sheltered domestic market, accelerated depreciation, soft loans and high leverage. This type of Government support amounts to a tacit guarantee to investors and results in virtual indifference by shareholders and creditors to low short-term profitability.

The ability of U.S. semiconductor companies to compete internationally has been significantly set back by the current recession. For 1981, revenues from most semiconductor products increased by very small amounts compared to historic trends, if they increased at all, and profits were down dramatically. The picture for 1982 is slightly better. However, the U.S. industry is continuing to invest in R&D and in new equipment at a record pace. The industry does not want to be caught without the technology or the manufacturing capacity to deliver the volume of products which will be demanded once the economies of the world begin their recovery.

The 1981 Economic Recovery Tax Act provided significant incentives for our industry to expand its investments, particularly in research and development activities. We appreciate the efforts made by the members of this Committee last year in helping to enact these proposals. We hope that, by working with you in the future, we can together improve the incentives and apply them to increase the levels of investment and R&D undertaken by U.S. corporations.

1982 Tax Proposals

For many semiconductor manufacturing companies, the Administration's 1982 tax proposals and variations of those proposals which have been discussed by members of this Committee can have a seriously detrimental impact on the incentives enacted last year. We believe it important to bring this impact to your attention. The fact that we do so, however, does not mean that we oppose all tax increase proposals or that we even necessarily oppose all proposals which might increase the tax liability of SIA-member companies. However, we do believe that, in fashioning any tax proposals for this year, certain general principles ought to be followed.

The Need for Stable Tax Policies

First, for any tax policies to have an impact on corporate planning, they must be available over a relatively long period of time. My company, like most companies, is today making investment, marketing and other planning decisions that will affect our company's operations three, four and five years from now. If the tax incentives now in place are to have an impact on those planning decisions, as Congress intended in enacting them, we must have some degree of certainty that those incentives will continue to be part of the tax laws at least for the near future.

Current proposals relating to the DISC provisions provide an important example of the effect of legislative uncertainty. Intel, like most semiconductor manufacturing companies, exports large volumes of products from the United States and also engages in substantial foreign manufacturing. Decisions to export or manufacture abroad are, of course, influenced by any number of factors. Among these factors is the U.S. tax treatment of exports. For the past ten years the United States has through the DISC provisions encouraged U.S. companies to export rather than manufacture abroad. Yet in planning for the future, the status of DISC benefits has during the past year become uncertain. On the one hand there has been talk in the Treasury Department of repealing DISC. On the other hand, Executive branch officials have publicly considered repealing DISC and replacing it with a similar and somewhat more generous incentive. And now the Administration proposes subjecting DISC benefits to its alternative corporate minimum tax, which for Intel and other semiconductor manufacturing companies could significantly erode the DISC benefits currently received. In such an environment it is difficult for any company to determine whether substantive U.S. tax benefits for export activities will continue or whether from a tax viewpoint future advantages will arise for manufacturing abroad. This must be considered along with the significant tax incentive advantages consistently provided by other countries.

The Need For the Clear and Certain Application of Existing Policies

Our second general principle is that, if incentives are to be continued in the future, they should not be provided in a half-hearted or uncertain manner. That, in our view, is the fundamental problem with adopting a corporate alternative minimum tax to raise revenues: its substantially increases the degree of uncertainty for any company attempting to determine its ability to take advantage of existing tax incentives in future years.

The effect of the corporate alternative minimum tax on the R&D credit provides a simple illustration of this point. The purpose of the credit is to provide an incentive for increased R&D activities by lowering the after-tax cost of increased expenditures for R&D. However, a company attempting to determine what R&D projects it will fund in 1983 (the first year the Administration's minimum tax would be effective) cannot necessarily determine whether or not the credit will be available with respect to any increases in R&D in that year. If the company believes it will be sufficiently profitable in 1983 so that its effective regular tax rate (after all credits) will exceed 15 percent of its taxable income, it can assume that it will obtain the benefits from the credit. However, if a company for 1983 believes it could have a low level of profitability or if it just isn't sure in a highly volatile market place, so that its R&D credits, when combined with its investment and other credits, could reduce its corporate tax liability below 15 percent, the company could lose part or all of the 1983 benefit of the R&D credit under the proposed corporate minimum tax. Yet, if the company projects that it could have losses instead of profits in 1983, the company may again be able to obtain the benefit of its R&D credit in 1983, because (as we understand the Administration's proposals) the credit can be carried back to pre-1983 years and allowed to reduce tax liability in those years without regard to the minimum tax. Thus, particularly in years of economic uncertainty, the corporate minimum tax substantially increases the difficulty of the financial planner or the tax manager in attempting to project the impact of the credit, and other tax incentives, on their corporation.

Unintended and Detrimental Impact of Proposals

The third general point we wish to make is that in considering tax increase proposals, this Committee should avoid any "quick fix" proposals to raise revenues at the expense of long-standing tax or economic policies without a careful consideration of the complete implications of those proposals. This point can be illustrated by a review of the impact of the Administration's tax proposals, including the corporate minimum tax, on companies with short-lived assets.

Under the Accelerated Cost Recovery System (ACRS) enacted last year, most equipment is required to be depreciated over five years. Part of the rationale for enacting ACRS was the simplification which could be achieved by abandoning the concept of useful lives with respect to equipment depreciation. Moreover, ACRS obviously provides substantial benefits for long-lived equipment. However, for shorter lived equipment, such as most of the equipment of semiconductor manufacturing companies, under ACRS depreciation deductions were decreased, not increased.

Let me emphasize this point, because it is not generally understood. With respect to much of the equipment of semiconductor manufacturing and other high technology companies, ACRS decreased rather than increased many companies' depreciation deductions for tax purposes. More importantly, under ACRS the depreciation deductions permitted for tax purposes is, for most high technology companies, now smaller than the depreciation expense required for financial reporting purposes; indeed, the deduction is significantly smaller than the amount of true depreciation that arises with respect to most equipment under any economically realistic measure of such depreciation.

In my own company, most of our manufacturing equipment is depreciated over four years for financial reporting purposes; others may use even a shorter life. In many ways our company would prefer to use longer lives for financial reporting -- that would be one way to increase our reported earnings to our shareholders. However, in fact our manufacturing technology changes at a sufficient rate that much of our equipment becomes technologically obsolescent within a period of time that approximates three or four years. Thus, a three- or a four-year life reflects economic reality. Nonetheless, for tax purposes the equipment is assumed to have a five-year life.

Our company and high technology companies generally did not object to the fact that under ACRS depreciation deductions were required to be smaller than deductions which would reflect true economic depreciation; ACRS was a package of depreciation and investment tax credit proposals and provided a significant increase in the investment credit for equipment depreciated for tax purposes under prior law over three or five years. Taking into account the changes in the investment credit, most high technology companies were at least no worse off under ACRS than under prior law.

However, the Administration's 1982 tax proposals indicate that the adoption of the ACRS provisions and the abandonment of the concept of useful life have a tax impact beyond the direct measurement of depreciation deductions for regular tax purposes subject to investment credit offset. For example, under the Administration's proposal ACRS depreciation deductions are utilized in measuring income to be subject to the corporate minimum tax while no investment credit offset is permitted. For companies with short-lived equipment, this feature of the proposal has a perhaps unintended impact: their depreciation deductions for minimum tax purposes are generally smaller than the amount which would be properly deductible in measuring economic income. Presumably, the concept behind the Administration's minimum tax proposal is that each company should pay some tax on their "real" income. However, it is unlikely that the Administration or any member of this Committee intends that a company be required to pay minimum tax even where a company has no real or economic income. Yet, that is exactly what can happen under the Administration's proposal with respect to companies with short-lived equipment.

A second example of the deterimental and presumably unintended impact of the disregard of actual useful lives for short-lived equipment appears in the Administration's proposals with respect to industrial development bonds. Some semiconductor manufacturing companies, and certainly many electronics companies generally, have been significant users of small issue industrial development bonds. They have provided one way for new and expanding companies to obtain the financing necessary to establish new facilities in communities across the country. The Administration proposes to limit the benefits of these provisions through a number of proposals. One proposal is to deny ACRS depreciation deductions to equipment financed with tax-exempt industrial revenue bonds. Instead, such equipment is to be depreciated on a straight-line basis over 12 years. Presumably, this provision was intended to deny taxpayers utilizing industrial development bond financing any additional tax incentive under ACRS. However, as described above, short-lived equipment of high technology companies receives no such special benefit under ACRS. By forcing high technology companies to depreciate their equipment over 12 years to the extent purchased under industrial development bond financing, the Administration is proposing a serious tax penalty on these companies.

Possible Committee Tax Proposals

The above comments apply not only to the Administration's proposals but to possible expansions of those proposals by this Committee, as such expansions have been reported to date in the press. We understand that at least some members of this Committee are contemplating extending the Administration's corporate minimum tax proposal by adding various other items of preference for that tax. We would like to take a moment to comment on the impact of at least some of these proposals.

Treatment of R&D Expenses. There have been statements in the press that the Committee may consider requiring some portion of R&D expenses to be amortized over a period of time rather than deducted currently for corporate minimum tax purposes. We would oppose any such proposal in the strongest way possible. It is our firm belief that the expansion of private sector R&D activities is essential to the competitiveness of U.S. companies in international markets and for increases in the productivity of American workers. Any minimum tax proposal which treats R&D costs in a detrimental fashion would provide a significant disincentive for new R&D expenditures. Surely such a disincentive cannot be good economic policy at any time and is particularly inappropriate now.

Moreover, there are strong tax policy, as well as economic policy, arguments against such a proposal. For virtually all accounting purposes -- including financial as well as tax accounting -- R&D expenses have traditionally and consistently been allowed as a current expense or deduction. Expenditures for R&D activities are not like expenditures for equipment or even like expenditures for drilling an oil well. Admittedly, sometimes R&D expenditures result in the creation of a specific asset (e.g., a patent or technical "know-how"); other times they result in nothing at all or nothing more specific than a generally increased body of knowledge. Thus, any determination of what, if any, R&D expenditures are related to which, if any, specific assets is inherently unclear and uncertain. For this reason, distinguishing between R&D which is properly expensed (because it does not give rise to any specific asset) and R&D which conceivably should be amortized is literally impossible. Thus, any proposal to require the amortization of some portion of R&D expenditures for minimum tax purposes would create either an impossibly complex provision or an arbitrary provision which could cause major distortions.

Denial of Foreign Tax Credit. We understand that at least some members of this committee are considering a requirement that foreign taxes be treated as a deduction and not as a credit for purposes of the corporate minimum tax. Again, we would strongly oppose such a proposal. The semiconductor industry can only be competitive in the United States if it is competitive in worldwide markets; the continual cost reductions that are crucial to a U.S. company's ability to compete can only be obtained by manufacturing and selling in volumes permitted by worldwide rather than merely U.S. markets. If foreign taxes were disallowed as a credit for any U.S. tax purpose, the ability of U.S. companies to compete internationally could be adversely affected. Companies from other countries without exception either pay no tax in their home country on their foreign income or at the very least are allowed a credit for their foreign taxes. If no foreign tax credit is allowed in the United States, U.S. companies would be required to bear a double tax (the local country tax and a U.S. tax) on their income. That would mean lower profits and, in a price-competitive industry, fewer sales outside of the United States and, thus, ultimately lower profits and fewer sales within the United States as well. Although denying the foreign tax credit for corporate minimum tax purposes might in the short-run raise a small amount of revenue for the Federal Government, with respect to the semiconductor industry it could in the long-run lead to a decline for the industry and thus a reduction in Federal tax revenues.

Income from Possessions Corporations. There have also been press statements that the Committee might consider subjecting the income of possessions corporations to the proposed minimum tax. Such a provision would seriously erode the incentives for U.S. corporations to invest in Puerto Rico and could have a substantial impact on the Puerto Rican economy. The existing incentives have attracted to Puerto Rico a large number of investments that might otherwise have been made in foreign countries. Thus, it would seem counterproductive for the United States to enact legislation which would reduce, if not eliminate, the relative advantages of investing in Puerto Rico.

ACRS Deductions. Finally, it is our understanding this Committee is seriously considering including some portion of the tax benefits associated with ACRS depreciation deductions as a minimum tax preference. While we offer no view on the merits of such a proposal in general, we urge that, if such a proposal is considered, the circumstances of companies with short-lived equipment be taken into account.

The existing minimum tax for individuals contains a preference with respect to ACRS depreciation deductions on leased equipment. That preference is measured by the excess of the ACRS deduction in any year over the deduction which would be allowed had the equipment been depreciated over eight years on a straight-line basis. Presumably, that measurement of the ACRS preference assumes that the amount of acceleration in depreciation deductions under ACRS for all equipment at least equals that excess. But, for short-lived equipment, such a measure of the tax incentive or benefit from ACRS is just plain wrong. As was described above, little if any equipment of my company and other semiconductor manufacturing companies could ever properly be depreciated over as long a time as eight years. Requiring these companies to pay minimum tax on the basis of eight-year, straight-line depreciation deductions would constitute a substantial distortion of income and would result in sizable tax liabilities even for companies that are clearly unprofitable. Surely, such a proposal makes no sense from either an economic policy or a tax policy point of view.

If some preferences with respect to ACRS deductions must be considered, the preference must be limited to any deductions permitted under ACRS in excess of some measure of economic depreciation. For example, the preference could be either (1) the amount of any ACRS deduction in excess of the depreciation deduction allowed under the straight-line method over some arbitrary period (such as eight years) or, if less, (2) the excess of the ACRS deduction over the depreciation deduction that would be allowed using actual useful lives (and depreciation methods) adopted for financial purposes (or, in the case of privately held companies, for tax purposes prior to the 1981 Act).

Conclusion

We urge that whatever tax proposals this Committee decides to adopt this year, the proposals affecting business tax incentives should not be adopted as temporary palliatives for our short-run economic problems. Rather, the proposals should be consistent with the longer-run strategy of economic and business growth implemented in the 1981 Act. Only in this way can companies have the ability to plan for the future in these uncertain times.

Senator **CHAFEE**. Thank you. We will have some questions. Why don't we take each of the statements now. That was a good statement, Mr. Perlman.

Mr. Cherecwich.

STATEMENT OF PAUL CHERECWICH, SCIENTIFIC APPARATUS MAKERS ASSOCIATION, WASHINGTON, D.C.

Mr. **CHERECWICH**. Gentlemen, my name is Paul Cherecwich. I am the corporate tax manager for the Foxboro Co. in Foxboro, Mass. In 1981, my company had $607 million worth of sales, approximately 50 percent of which were outside this country.

I am here this morning representing the Scientific Apparatus Makers Association in my capacity as chairman of their tax committee. They are a 180-member trade association based in Washington, representing the instrumentation industry.

SAMA took a survey of its members last year to find out how much money was spent on R. & D. And the statistics were impressive; 5.6 six percent of sales, which represented 87 percent of after-tax profits, and 150 percent of capital expenditures. This industry has sales of $12 billion of which over one-third were exported. Clearly, there is a linkage between the investment in R. & D. and the amount of significant exports for this industry.

We recognize that the Congress is currently faced with a revenue expenditure dilemma. We understand and we are not necessarily opposed to a need to increase taxes. We do hope, however, that in attempting to solve one problem, another series of problems is not created.

We specifically believe that the administration's proposals in the completed contract area, corporate minimum tax area, and tax-exempt revenue bond area will create these problems.

In the completed contract area we are concerned about the administration's regulatory proposals. Particularly, for those taxpayers that use the accrual shipment method of accounting rather than the completed contracts method of accounting, the administration's regulatory proposals are quite sweeping and would add a very high administrative burden. My written testimony contains numerous examples of that burden.

In the legislative area, the administration's completed contract proposals would seriously affect one of the major techniques of financing that are used by our industry. It is quite common in our industry for us to ask for downpayments or periodic or progress payments in connection with our contracts that happen to extend more than 6 months long. We use this as a means of financing so we can free up other cash to spend on the R. & D. activities.

Senator CHAFEE. OK. We will have a lot of testimony on that. We appreciate your thoughts, but could you move to the issue of tax-exempt revenue bonds? That's a new field and something we are not so familiar with.

Mr. CHERECWICH. Yes, sir. Industrial revenue bonds, the administration believes, were abused because too many people used them last year. High technology companies and SAMA member companies have used the industrial revenue bonds as a means of building new plants and equipment. We do not believe that users of small-issue industrial revenue bonds is something that is detrimental to our country's economy. We think it is pretty good. The administration has said that ACRS combined with small-issue industrial revenue bonds is creating a significant benefit. We do not believe that is so because ACRS has not been a panacea to high technology companies. We were already depreciating our assets over very short lives.

We think what Congress ought to do is look at some of the approaches that were proposed in the last session to further improve the usefulness of industrial revenue bonds for high technology companies by removing the R. & D. limitation on capital expenditures. I would like to address——

Senator CHAFEE. Wait a minute. I missed that. I am interested in this subject. You say industrial revenue bonds are fine for high technology companies. How about the other companies? In other words, aren't we getting into a situation where we end up with industrial revenue bonds for everything? How can we possibly restrict it to high technology companies? Sure, that's what you are for because you are in one. But why not for everything else? How about machine tool manufacturers?

Mr. CHERECWICH. So I believe the industrial revenue bond program is a good program. There have been some abuses that we have heard about in the popular press where there have been pornographic book stores in shopping centers. We have all heard about those. I don't think they are appropriate.

Senator CHAFEE. But do we really want to get in a situation where we've stretched tax-exempt bonds from building schools and waterworks to building everything in sight in this country?

Mr. CHERECWICH. Sir, the industrial revenue bond proposals already have a $10 million limitation for expenditures within a particular community. What these industrial revenue bonds are doing is enabling communities to attract manufacturing plants which provide jobs. They are preventing a concentration of manufacturing plants all in one area by spreading it throughout communities that need jobs close to where people are living.

Senator CHAFEE. Well, we can use that argument for industrial revenue bonds for any kind of a corporation. All right.

Mr. CHERECWICH. If I could comment on the corporate minimum tax then, sir. There were two points about the corporate minimum tax that we found to be very bothersome. One is the inclusion of DISC deferred income as a tax preference. The DISC has been around since 1971 and those companies that have used the DISC have substantially increased their exports in accordance with our Government's policy. The DISC has worked so well that our European trading partners have complained in the GATT that the DISC is no good. The administration has just returned from Geneva having announced an agreement that the DISC would be allowed to continue under the GATT rules, and now we are turning around and playing into the hands of France, Belgium, and the Netherlands by wanting to put the DISC in the minimum tax. I do not believe that that should be there. It's not consistent with our export oriented policy.

I am also quite concerned about the absence of R. & D. credits against the corporate minimum tax. After ERTA passed the R. & D. credits last summer, SAMA took a survey of its members, and 86 percent of its members indicated they were going to increase their R. & D. expenditures as a result of ERTA. This is exactly what this legislation was intended to do. But the problem is if you increase R. & D. expenditures, you reduce profits. SAMA member companies are perfectly willing to suffer short-term profits because we have an incentive to do so through the tax credit, but now if you turn around and take that incentive away by denying R. & D. tax credits against the corporate minimum tax, we are going to simply destroy what the ERTA legislation was all about.

Senator CHAFEE. OK. Fine. Thank you, Mr. Cherecwich. I appreciate that testimony.

[The prepared statement follows:]

PREPARED STATEMENT OF PAUL CHERECWICH, JR.

Mr. Chairman and Members of the Committee:

My name is Paul Cherecwich, Jr. and I am the Corporate Tax Manager for The Foxboro Company, which is headquartered in Foxboro, Massachusetts. In 1981, my company had a total sales volume of $607 million. Of this amount, approximately 50 percent represented products sold outside the United States.

I am appearing before you today on the behalf of the Scientific Apparatus Makers Association (SAMA), for which I serve as Chairman of the Tax Committee.

SAMA is a national trade association representing this country's manufacturers and distributors of a wide range of scientific, industrial and medical instruments and equipment. The 180 companies who are SAMA members, many of small or moderate size, constitute the bulk of American industry producing research, laboratory, analytical, electronic test and measurement, and process measurement and control instruments, as well as clinical laboratory instruments, patient monitoring instruments, and a wide range of laboratory apparatus and equipment.

In 1979, SAMA member companies expended an average 5.6 percent of their sales on research and development activity. This number represented 86.9 percent of after tax profits, and 150.9 percent of capital expenditures. SAMA companies are clearly R&D oriented and R&D dependent.

In 1980, the industries represented by SAMA produced and shipped products valued at over $12 billion. Exports accounted for about one-third of total sales, although for some SAMA companies, exports may amount to 50 percent or more of total sales. Since over a third of our industries' total sales are related to exports of U.S. products, it is obvious that a substantial number of the jobs of more than one-quarter of a million U.S. workers employed by our industries are directly dependent upon international trade, and the competitiveness of the United States in world markets. It should also come as no surprise that those businesses which have expended funds on R&D in the past have been successful in the international marketplace.

I am appearing before you today to comment upon the tax revisions and improved collection and enforcement proposals announced in the President's State of the Union Address on January 26, 1982, and as explained in the Department of Treasury Release dated February 26, 1982.

At the outset, let me say that I understand and I am sympathetic with the need for Congress and the Administration to address the realities of the economic situation now being faced by our country. There are many persons much more qualified than I to address the question of how best to raise revenues to achieve a balanced budget. At the same time, I believe that there are certain aspects of the Administration's tax proposals which will have a serious, long-term adverse impact on SAMA members and other high technology companies which may not be fully understood by the Administration or by members of this Committee. Therefore, I will limit my comments to those proposals likely to have small revenue impact to the U.S. Treasury but a large economic impact on the future growth of scientific, industrial, medical and related industries represented by SAMA.

Specifically, we believe that the completed contract accounting proposals, tax exempt revenue bond proposals, and corporate minimum tax proposals will, if enacted as proposed, have an adverse effect upon high technology industries beyond mere revenue impact. Enactment of the proposals is likely to be detrimental to the ability of our industries to compete in the world marketplace in the years ahead.

Completed Contract Method of Accounting

The Administration has proposed a two-pronged approach to the issue of completed contract accounting. The first approach would amend existing regulations, while the second approach would require new legislation.

In general, taxpayers may account for contracts that extend beyond a single tax year by using one of three methods of accounting. Two such approaches are the completed contract method and the percentage of completion method. These methods commonly bring to mind the construction of buildings, highways, dams and other facilities, and the custom manufacturer of aircraft, ships, and heavy industrial machinery. Most high technology firms do not use either of these methods of accounting. Rather, high technology firms use a third method of accounting known as the accrual shipment method for contracts that extend beyond a single tax year. The accrual shipment method of accounting requires that existing inventory regulations be followed, including the application of full absorption costing, with income and the corresponding cost of sales recognized when all goods in a contract have been shipped.

The Administration's regulatory proposals first amend the completed contract costing rules under Regulation 1.451-3(d) and then amend the inventory rules under Regulation 1.471-11 to provide that a taxpayer using an inventory method of accounting for a long term contract must use the same costing rules as taxpayers using the completed contract method. Such rules will be unduly burdensome to the high technology industries unless the regulations recognize the sheer volume of individual contracts likely to be covered.

For example, the technical explanation suggests that general marketing, selling, and advertising expenses will be exempt from the full costing rules, along with bidding expenses incurred in the solicitation of contracts not awarded to the taxpayer. By implication, bidding expenses incurred in the solicitation of contracts awarded to the taxpayer must be included in indirect costs which are allocated to long term contracts. For taxpayers reporting the results of many small contracts on the accrual shipment method of accounting, this would impose an impossible accounting burden. Such taxpayers typically lump all selling expenses into one account, with no attempt made to separate selling expenses into success or failure accounts. A solution to this problem might be to exempt from allocation to long term contracts those bidding expenses incurred in the solicitation of contracts awarded to the taxpayer where the taxpayer normally treats such expenses as general selling expenses (period expenses) for purposes of financial reporting.

We also note that the Administration proposes to amend Regulation 1.451-3(d) to require the allocation to long term contracts an appropriate part of indirect costs not directly benefiting long term contracts. A comparison of the exceptions proposed by the Administration to this rule with the exceptions currently listed in the regulations leads to the conclusion that the Administration wishes to abolish the deductibility of period costs. In addition to creating a tax system under which revenues and expenses are no longer matched, such an approach would impose large new accounting burdens on high technology firms, along with a corresponding increase in audit problems for both the taxpayer and the IRS.

The Administration also proposes that taxpayers using an accrual method of accounting for multi-unit contracts must account for sales of the various items when each item is delivered or shipped, or when title to individual items passes to the customer. Large orders for SAMA companies are typically comprised of many individual items. As a matter of convenience to both the seller and the buyer, it is common practice in our industries to ship instruments or other equipment as soon as manufacturing has been completed. For insurance purposes, title to the individual items normally passes to the customer upon shipment. Amendments to Regulation 1.461-1(c) would impose an enormous accounting burden on small high technology companies if large contracts had to be accounted for in many bits and pieces.

The Administration additionally proposes to amend Regulation 1.451-3, so that contracts will be considered complete without regard to any obligation on the part of the selling company to supervise installation of the subject matter of the contract. SAMA believes this provision is arbitrary, and one which flies in the face of reality. If a customer who has purchased industrial instrumentation does not consider a contract complete until he has installed the instrumentation and verified that it is functioning properly, why should a taxpayer be forced to assume for income tax purposes that its contract is complete?

Although the regulatory proposals, if put into effect, would cause additional accounting problems for many high technology companies, the Administration's proposal for a new Code Section 451(f) entitled "Special Rule for

Accounting for Long Term Contracts" would cause significant fundamental problems. In attempting to correct a perceived problem in selected industries (construction of buildings, highways, etc., and custom manufacturing of aircraft, ships, etc.), the proposed legislation would directly and negatively affect SAMA companies. Under the Administration's proposal, taxpayers must use either the progress payment method of accounting or the percentage of completion method. Under the progress payment method, the Treasury explanation appears such that any payments received from any source would be considered progress payments. Because of a great need for capital to finance research and development activities, many SAMA firms have turned to their customers for assistance in financing production contracts. Thus, advance payments are obtained from customers for use as working capital.

Under the Administration's legislative proposal, taxpayers would not be allowed to use the accrual shipments method of accounting presently allowed under the inventory regulations, but rather would be forced to report the financing payments received from customers as income at the time of receipt. Such a provision would defeat the basic purpose for which advance payments are solicited from customers, and would have a profoundly adverse impact upon the ability of our industries to maintain their existing levels of R&D expenditures.

In all candor, it appears that the Administration is unaware of the sweeping nature of its proposals in the completed contract accounting area. The regulatory proposals would impose an extra accounting burden on many high technology companies without a particularly large speed-up in tax payments. The legislative proposals would have an absolutely devastating effect on one of the methods used by SAMA companies to raise capital, (i.e., advance payments from customers), and would no longer provide the cash flow previously available. This, in turn, would seriously curtail our industries' R&D efforts.

Tax Exempt Revenue Bonds

The Administration has noted that the volume of tax exempt bonds issued for non-government users has grown rapidly during the past five years, with the largest increase occuring in small issue bonds. SAMA and other high technology companies have been a large user of small issue industrial development bonds. The Administration appears to believe (at least as inferred from the Treasury explanation) that it has been detrimental to our country's interests to help high technology firms find necessary capital, in spite of the fact that it is these very firms which have helped to provide so many of the new products, exports and jobs necessary for our country's economic health. The Administration apparently also believes that in combination with the Accelerated Cost Recovery System (ACRS), tax exempt financing can result in a substantial negative tax or subsidy for qualifying activities.

We believe it is important to emphasize that the ACRS enacted last year was not a panacea to high technology companies. In fact, although SAMA supported ACRS in 1981, our members and other high technology firms did not benefit directly from its provisions, since many of these firms were already using accelerated methods of depreciation over shorter asset lives than currently allowed by ACRS. This was one of the reasons why we were especially grateful when the Congress and Administration decided to address the unique problems of high technology companies head-on, and enacted credits for research and development expenditures.

High technology companies, and in particular SAMA firms, require every bit of help they can get to raise capital in order to maintain their high level of R&D expenditures and, thus, their competitive position in the world marketplace, and the continuation of the growth of their export capabilities. Rather than limit the usefulness of industrial development bonds for high technology companies now, SAMA believes Congress should, in the near future, consider increasing their usefulness by removing R&D expenditures from the capital expenditure limitation presently found in the statute.

New Corporate Minimum Tax

The Administration has determined that many corporations presently pay little or no federal corporation income tax, despite reporting large profits to their shareholders. In order to correct this problem, the Administration proposes to create an expanded list of items of tax preference subject to a new alternative minimum tax, and to limit the amount of credits which could be taken against such a tax.

As stated earlier, high technology companies require a sustained cash flow in order to maintain and improve their existing level of R&D expenditures, which will, in turn, help maintain their competitiveness in world marketplaces. R&D cannot be financed with mortgages or other long-term financing vehicles; R&D must be paid for currently out of cash flow. Thus, the addition of any item of so called tax preference or the denial of any tax credits which affect high technology industries will affect cash flow, and have a direct impact on their ability to continue to finance R&D.

The Administration proposes that accelerated depreciation on real property should be considered an item of tax preference. We believe the Congress has already written into the law sufficient safeguards against abuse from accelerated depreciation on real property, by requiring that any gain from the sale of property which has been depreciated using accelerated depreciation be considered as ordinary income rather than capital gains income. Thus, it is our view that this item of tax preference is not required.

Deferred Domestic International Sales Corporation (DISC) income would also be considered an item of tax preference under the Administration's proposal. This item would have a very serious impact on high technology companies, which have been taking the lead in U.S. exports. DISC has been extremely valuable as an export incentive to SAMA companies and other high technology exporters; so valuable, in fact, that some of our trading partners have complained to the Secretariat for the General Agreement on Tariffs and Trade (GATT), and have attempted to have this incentive eliminated. The Administration has just concluded a successful fight in Geneva to enable the United States to maintain DISC under the GATT rules. To now turn around and make deferred DISC income an item of tax preference for the corporate minimum tax would defeat the very reason for the DISC in the first place, and impose its major burden on those high technology companies which have been most successful in pursuing an important national goal; i.e., increasing U.S. exports. We do not believe that treating deferred DISC income as a tax preference would further the government's objective to increase exports; it would, in fact, have just the opposite result.

The Administration has taken the position that no credits other than foreign tax credits should be allowed to offset the new minimum tax. Under these circumstances, SAMA is particularly concerned about the continued usefulness of the R&D credit recently enacted into law.

To put this concern into perspective, SAMA conducted a survey of its membership following the enactment of the Economic Recovery Act of 1981 (ERTA). Results of this survey show that ERTA will cause 86 percent of responding SAMA companies to to increase their R&D activities, with over one-half the companies expecting an increase in 1982 beyond what they had originally planned to spend in the R&D area. Thus we foresee that ERTA will have its desired impact in our industries.

Ours are among the very industries which have been characterized by current low profitability as a result of their heavy current R&D expenditures. Last year, we received what we view as a major encouragement under ERTA to continue R&D expenditures, in spite of the impact on current profitability. Yet the Administration now proposes to take that incentive away with a corporate minimum tax against which the R&D credit will not be allowed. This will serve to defeat the very purpose for which the R&D credit was enacted, i.e., to help the high technology low or no profit company find the capital resources necessary to continue high levels of R&D expenditures.

The adverse impact of the Administration's minimum tax proposals on high technology companies may be unintended. We hope so. Rather than penalizing high technology companies, we hope the Congress will consider in the near future the following issues on which action was postponed under ERTA.

1. ERTA suspended for a two year period regulation 1.861-8 as it applied to the allocation of domestic R&D expense to foreign source income. As explained earlier, high technology companies have been in the forefront of U.S. export activity. Such companies are often required to establish sales and service operations abroad in order to expand and support their exports. Such operations are naturally taxable by the host government. Normally such taxes are creditable in the U.S., but where a foreign operation makes use of technology from the U.S. in order to further U.S. exports, Regulation 1.861-8 would operate to deny tax creditability. The two year suspension should be made permanent.

2. ERTA, as enacted, provided an R&D credit for expenditures in excess of base period expenditures. Qualified research expenditures include amounts paid for basic research by colleges and universities. Legislation introduced last year in this area exempted such expenditures from the base period calculations on the grounds that a revitalization of university/industry cooperation in basic research was needed, and all possible incentives should be given to accomplish this objective. That concept is still valid, perhaps more so today than a year ago, and SAMA believes Congress should remove the requirement to include Section 44F(e) expenditures in the base period computations.

3. ERTA also provided a special deduction for charitable contributions of scientific property used for research by colleges and universities. However, new Code Section 179(e)(4) is limited to contributions of inventory. We believe our country's technological health would benefit if industry were also encouraged to donate depreciated production and laboratory assets, along with inventory. Thus, Congress should expand Section 179(e)(4) to allow a deduction for the fair market value of Section 1231 assets donated to colleges and universities for use in research.

We believe these issues will have minor revenue impact in the short run, but very favorable overall economic impact in the future, and we hope that serious consideration will be given to each of these proposals later this year.

Conclusion

In conclusion, Mr. Chairman, SAMA understands the revenue/expenditure dilemma now being faced by the Congress and the Administration, and we are sympathetic with efforts underway to resolve the dilemma. We do not necessarily oppose proposals which will increase our companies' tax liability. We do hope, however, that in attempting to solve one problem, another series of problems is not created. Specifically, SAMA believes that the Administration's proposed tax revisions and improved collection and enforcement proposals, if unaltered, will have a fundamentally negative impact upon our high technology industries in at least three areas:

1. Completed contract accounting;
2. Tax exempt revenue bonds, and
3. Corporate minimum tax.

With regard to the regulatory proposals in the completed contract accounting area, the Administration would impose a significant accounting burden on high technology companies using the accrual shipments method of accounting, in return for only a change in the timing of revenue collection. These proposals should not be put into effect.

With respect to the completed contract accounting legislation proposals, the Administration would remove a very significant source of financing for SAMA members, i.e., advance payments from customers. The accrual shipment method of accounting should be allowed to stand for high technology companies.

The Administration's proposal with respect to tax exempt revenue bonds is based in part on the assumption that high technology companies have benefited from ACRS, whereas in many cases the reverse is true. Rather than attempting to limit the use of industrial development bonds, the Administration should encourage their use by removing R&D expenditures from the limitation of capital expenditures presently found in the law.

Finally, the Administration's proposals on the corporate minimum tax are we believe, defective in several areas. The most flagrant deficiency, in our view, is the attempt to include deferred DISC income as a preference item, when to do so would be to offer our foreign competitors exactly what they have been looking for in the GATT for several years. Also, to deny the use of the R&D credit against the corporate mimimum tax would be to penalize those very corporations for whom the R&D tax was intended to be a major incentive in connection with our country's need to maintain its technological edge.

SAMA believes that instead of attempting to penalize high technology companies before ERTA has had a chance to work, Congress should give early consideration those R&D issues postponed under ERTA and:

1. Make permanent the suspension of Regulation 1.861-8 as it applies to R&D expenses;

2. Remove Section 44F(e) university research expenditures from the R&D credit base period, and

3. Add an additional charitable deduction under Section 179(e)(4) for the fair market value of depreciated assets donated for use in university R&D.

Mr. Chairman, SAMA thanks you for the opportunity to present these views.

STATEMENT OF G. KENNETH CHRISTRUP, DIRECTOR OF TAXES, XEROX CORP., ON BEHALF OF ROCHESTER TAX COUNCIL, ROCHESTER, N.Y.

Senator **Chafee**. Mr. Christrup.

Mr. **Christrup**. Thank you, sir. I'm Kenneth Christrup and I appear before you today as past chairman of the Rochester Tax Council. The council members include Eastman Kodak, Bausch & Lomb, Inc., Champion Products, Gannett, Xerox, and others.

The council membership is limited in number so they can quickly respond to tax proposals and hopefully constructively evaluate those proposals. Consistent with the past practices of the council, our testimony today will reflect our——

Senator **Chafee**. I wonder if you could pull that mike a little closer to you. It's a little hard to hear you.

Mr. **Christrup**. Consistent with the past practices of the council, our testimony today will reflect our concensus on the administration's proposals that are relevant to our members. More detailed and extensive written positions have been filed with the committee. The following is a summary of some of those comments.

Regarding the completed contracts method, even assuming that some adjustments may be required in the calculation of income and the timing of deductions under the long-term contract method, this combined legislation and regulatory proposal is overkill. It reaches many contracts and many taxpayers who do not use the completed contract method. It's far beyond the scope of the Treasury's rationale for the proposal.

Some of the smaller companies in the council have used the completed contract method in connection with a limited portion of their business. If any changes are required, at a minimum, some exception would be in order for smaller contracts for companies reporting only a limited percentage of their income under the completed contract method.

Regarding construction period interest and taxes. While this proposal would defer certain deductions for members of the council, we have no serious objections. Neither do we have any comments regarding energy credits or the tax-exempt revenue bonds because most of our council members do not extensively or to any great degree use those measures.

Corporate minimum tax. The council strongly opposes the proposed corporate minimum tax. As economic policy it is wrong because it confuses and indirectly undercuts key incentives that Congress put into the tax law, including the accelerated cost recovery system which was the centerpiece of the administration's business tax policy only last year. This is principally because of the disallowance of the investment tax credit. The usefulness of the investment tax credit will be in doubt and the economic incentive intended from this provision will be undercut not only in those situations where the minimum tax is due, but also in the very large number of cases in which the taxpayer will be uncertain when an order is placed about how useful the credit is going to be.

As tax policy, the proposed corporate minimum tax is wrong because it will greatly complicate the Federal corporate income tax. The new proposal would require most companies to calculate and plan on the basis of two different definitions of taxable income, two tax rates, and two sets of available credits.

Senator CHAFEE. Poor old corporate minimum tax is taking a kicking around here today, isn't it?

Mr. CHRISTRUP. I would think it would be. Yes, sir. Because it does seem to undercut what was just done last year. I think the main concern is there is some talk—even though it's not in the administration's proposal—of perhaps not allowing the foreign tax credit. And the other, of course, is the fact that you know you are really losing the investment tax credit which is as important to you if not more so than the accelerated depreciation.

Senator CHAFEE. Well, as you know, Senator Dole, when he has discussed it there, has talked in terms of 15 percent.

Mr. CHRISTRUP. Yes, sir.

Senator CHAFEE. Do all these objections coming from corporations indicate these corporations are currently paying less than 15 percent?

Mr. CHRISTRUP. Probably not. I think the concern is in the future, as to the investment planning for what could happen. I have seen reports in the paper where there are even carrybacks of course of investment tax credit.

Senator CHAFEE. OK. By OK I mean go ahead.

Mr. CHRISTRUP. OK. Anyway, notwithstanding the serious economic and tax policy drawbacks of this proposal; if Congress does adopt some new form of corporate minimum tax, the council urges you to modify the proposal as follows: (1) For the reasons stated the investment tax credit should be allowed as a credit against a minimum tax, except possibly investment tax credit passing to a taxpayer under section 168(f)(8)—the safe harbor tax leases, (2) DISC income should not be attributed to shareholders as an addition to corporate profits. With the possible exception of a limited shipping subsidy item, this is the only item in the proposed fourteen preferences that involves adding an item of income rather than disallowing a deduction, and (3) as I indicated earlier, while the Treasury does allow the foreign tax credit against the proposed corporate minimum tax, some have raised a question about this allowance. The council strongly opposes any disallowance of the foreign tax credit or other steps to erode this essential element protecting against international double taxation.

Again, the council would not object to withholding on dividends and interest. It is concerned about the proposals regarding accelerated income tax payments because, simply, we have some of the larger corporations in our group, and we don't have the ability to estimate income on a monthly basis where we could get that close to our actual tax liability. What they are proposing is effectively a 37-percent cost for the use of money if you miss on your estimated tax and it would seem to us that the 20-percent interest rate is certainly sufficient to compensate for any underpayment of tax.

Thank you.

Senator CHAFEE. Thank you.

[The prepared statement follows:]

Statement of
G. Kenneth Christrup
Director of Taxes of Xerox Corporation
on Behalf of
The Rochester Tax Council
Before The
Senate Committee on Finance
on the President's 1982 Tax Proposals.

March 19, 1982

Mr. Chairman, I am Kenneth Christrup, the Director of Taxes of Xerox Corporation, and I appear before you today in my capacity as Chairman of the Rochester Tax Council. The Rochester Tax Council is a voluntary organization of companies having strong affiliations with the Rochester, New York, area. The Council members are:

Bausch & Lomb, Inc.
Champion Products
Gannett Co., Inc.
Garlock, Inc.
Gleason Works
Eastman Kodak Company
The R. T. French Company
Schlegel Corporation
Security New York State Corporation

Sybron Corporation
Xerox Corporation

The Council has regularly studied and addressed proposed federal tax legislation and has frequently testified before this Committee. We believe the Council is particularly well equipped to address these issues of tax policy because its membership is not limited to any particular industry, but includes companies engaged in manufacturing a wide range of diversified products throughout the world, and also a major newspaper and communication chain and a bank. Nevertheless, the Council membership is sufficiently limited in number that it can quickly and constructively evaluate tax proposals.

Consistent with the past practices of the Council, our testimony today will report our position on the Administration's proposals which are relevant to our members. While we must strongly object to at least some aspects of some of the Administration's proposals, there are others which we can accept even though they are detrimental to some or all of our members.

To date the Administration has not proposed specific statutory language, so that detailed analysis is difficult. Based, however, on the Treasury's General and Technical Explanations as released on February 26, 1982, our comments and positions are as follows (in the order presented by the Treasury rather than order of importance to the Council):

I. Completed Contract Method - Even assuming that some adjustments may be required in the calculation of income and the timing of deductions under the long term contract method, this combined legislative and regulatory proposal is overly broad. It reaches many contracts and many taxpayers beyond the scope of the Treasury's rationale for this proposal. It may surprise the Committee to learn that the Treasury proposal would deny the normal rules of the accrual method to taxpayers who have not even elected to use the completed contract method. Such taxpayers are not receiving the benefits of that method, are not receiving the deferral of reporting income under that method, and should not be denied the right to report income and deductions under the accrual method. Whatever justification there may be for requiring taxpayers on the completed contract method to change to the percentage of completion method or the progress payment method, there is no justification for requiring a taxpayer which reports income and deductions from long term contracts under the regular accrual method to change to one of these two special methods.

We do not possess the knowledge or expertise to address the many other aspects of this proposal, and leave that to parties more directly and deeply involved. However, some of the smaller companies in the Council have used the completed contract method in connection with a limited portion of their business. If any changes are required in this area, some exceptions would be in order for smaller companies of the size of these members of the Council which report only a limited percentage of their income under the completed contract method.

II. Business Energy Credits - In view of the existing "sunset provisions" governing these credits and the long lead time required for most business investments qualifying for these credits, we believe it would be unfair and poor tax policy to accelerate these "sunset provisions."

III. Tax-Exempt Revenue Bonds - Most of the members of the Council have undertaken projects financed with industrial development bonds. While industrial development bonds appear to have been helpful to the communities issuing them, if Congress believes this avenue for community incentives should be modified as proposed by the Administration, the Council would have no objections.

IV. Modified Coinsurance - This is an issue on which the Council has no knowledge or involvement and, consequently, has no comment.

V. Construction Period Interest and Taxes - While this proposal would defer certain deductions for members of the Council, we have no serious objections to it.

VI. Corporate Minimum Tax - The Council opposes the proposed corporate minimum tax. As economic policy, it is wrong because it confuses and indirectly undercuts key incentives that Congress has put into the tax law, including the Accelerated Cost Recovery System (ACRS) which was the centerpiece of the Administration's business tax policy only last year. Particularly serious is the disallowance of the investment tax credit. Businesses plan their acquisition of depreciable property well in advance of the year in which such property is finally placed in service. At the time when "Section 38 property" is ordered, it will normally be impossible to determine whether the business will be subject to the regular or the proposed minimum tax in the year in which the property is actually placed in service. Consequently, the usefulness of the investment tax credit will be in doubt, and the economic incentive intended from this provision will be undercut, not only in those situations where the minimum tax is due, but also in the very large number of cases in which the taxpayer will be uncertain when an order is placed about the usefulness of the credit. For these taxpayers, the impact will be much the same as an announcement by the Administration that it is considering a repeal or reduction of the investment tax credit. Taxpayers being uncertain of the availability of the credit will discount this incentive in making their capital investment plans.

As tax policy, the proposed corporate minimum tax is wrong because it will greatly complicate the federal corporate income tax. As noted by Treasury, the present corporate minimum tax affects few corporations. The new proposal will require most companies (other than those protected by the $50,000 exclusion) to calculate and plan on the basis of two different definitions of taxable income, two tax rates, and two sets of available credits. The actual double calculation is not the most serious part of this problem; more significant are the problems of estimating tax payments and, particularly, of evaluating what economic benefit, and therefore what incentive, is provided by the deductions and credits allowed under the regular tax, but disallowed under the minimum tax. Also, the proposed corporate minimum tax credit carryover would have the effect of reordering credits in a way which is difficult to predict. Record keeping for carryovers is already quite complex where audits redetermine credits and create credit carrybacks; this exacerbates this problem.

Aside from companies that would regularly pay only the minimum tax, the treasury recognizes that the net effect of the minimum tax is to accelerate the time of tax payments. Is this acceleration sufficient policy justification to support the complexity and undercutting of intended economic stimuli?

If some changes in the corporate tax, and in particular in those items impacted by the proposed corporate minimum tax, are deemed necessary by the Administration or by Congress, these changes should be addressed directly by a reduction or repeal of such items, and not by introducing new and duplicative corporate tax systems.

If, not withstanding the serious economic and tax policy reason drawbacks of this proposal, Congress does adopt some new form of corporate minimum tax, the Council urges you to modify the Treasury proposal as follows:

(1) For reasons stated above, the investment tax credit should be allowed as a credit against the minimum tax (except possibly investment tax credits passing to a taxpayer under Section 168(f)(8)), and

(2) DISC income should not be attributed to shareholders as an addition to "corporate profits." With the possible exception of a limited shipping subsidy item, this is the only item in the proposed fourteen preferences that involves adding an income item rather than disallowing a deduction. Any minimum tax base should be limited to normal income plus disallowed deductions. Furthermore, this DISC proposal introduces a number of policy questions not answered by the Treasury presentation. If the income of the DISC is added to its parent's taxable income in one year under the minimum tax, will the same income be taxed again to the

parent under the regular tax when it is distributed by the DISC to the parent in a later year? What impact will this preference have on the earnings and profits of the parent and of the DISC? How will the foreign tax credit limitation be calculated?

(3) The Treasury proposal does allow the foreign tax credit as a credit against the proposed corporate minimum tax, but some have raised a question about this allowance. The Council strongly opposes any disallowance of the foreign tax credit or other steps to erode this essential element protecting against international double tax.

VII. Withholding on Dividends and Interest - The members of the Council pay large amounts in dividends and interest which would be subjected to the proposed withholding tax. This proposal would certainly increase costs to payors. Nevertheless, if this Committee and the Congress conclude that such withholding is required to avoid substantial revenue losses and that the cost of such withholding is not disproportionate to the revenue raised, the Council would have no objections to this proposal.

VIII. Accelerated Corporate Income Tax Payments - The Council believes this proposal is based on a totally erroneous premise. The Treasury's General Explanation states, "Given the ability of corporations to estimate their income on a monthly basis, there is no longer any reason to permit corporations to underpay their taxes by up to 20 percent without any penalty." The ability of corporations to estimate income on a monthly basis is very limited and quite inexact. The members of the Council, which include two of the largest corporations in America, know from direct experience that it is not possible to estimate income with the accuracy required to meet the requirements of the Treasury proposal. We believe this Treasury premise is highly suspect and should be reexamined.

The Treasury proposal would impose a nondeductible penalty of 20 percent on any payments outside of a narrow 10 percent range of error. This is equivalent to a charge by the government of 37 percent for the use of money. Such a charge is unfair and unnecessary. Treasury does not propose making any comparable payment, or indeed any payment, to taxpayers who have in good faith overpaid estimated taxes. The government has use of these funds on an interest free basis.

At the same time the Treasury proposal would diminish the limited safe-haven rule for larger corporations. At a minimum, no increase in the percentage of estimated tax payments should be made without clear and reasonable safe-haven rules which can assure corporations that specific payments will provide protection against penalties.

The time has come to review entirely this subject. The concept of a "penalty" where there is a good faith effort to comply within very narrow guidelines is quite antediluvian and unfair. A 20 percent deductible interest charge is quite sufficient, and this same rate of interest should be payable by the government where the taxpayer in good faith has overpaid estimated taxes.

We appreciate the opportunity to present our views and look forward to working with this Committee and your staffs in the continuing evaluation of these proposals.

Senator **Chafee**. I would like to ask you gentlemen, particularly Mr. Perlman and Mr. Cherecwich, whether you are using the R. & D. tax credit which we passed last year. Do your people use that?

Mr. **Cherecwich**. Yes, sir.

Senator **Chafee**. Has that been proven an incentive to put more money into R. & D.?

Mr. **Cherecwich**. Yes; it has, sir. We have increased our R. & D. budget for 1982 as a result of the credit.

Senator **Chafee**. You are speaking as a member of the association?

Mr. **Cherecwich**. I am speaking as a member of my company, and our association. In taking a survey, 86 percent of the members said they would increase. And better than half said the increase would be 1982.

Senator **Chafee**. All right. Mr. Perlman.

Mr. **Perlman**. Yes sir, Senator, we have as well not only increased our R. & D., particularly, due to the credit, but we have also increased our university contributions based on that provision. In addition the existence of the credit has also been a deciding factor in some instances as to whether to do research within the United States or without the United States.

Senator **Chafee**. Now, Mr. Perlman, you indicated in your statement a deep concern about what the Japanese are doing and attributed their success, it seemed to me, to cost of money and government support in some instances. But that gets into the production end of the scale. And as you have indicated, the Japanese have taken—what did you say—70 percent of the 64K market in the United States?

Mr. **Perlman**. Roughly.

Senator **Chafee**. This is, indeed, troubling, but even more troubling, and a matter which has nothing to do with ability to produce and low cost of production, is your statement on page 3 noting that all five technical papers on the 250,000 ram, which will probably be the workhorse memory circuit of the late 1980's, were presented by Japanese. Now this seems to me straight R. & D. and doesn't have anything to do with production. Aren't these papers looking to the future?

Mr. **Perlman**. Yes, Senator. That's exactly the point. Our threat from the Japanese in the past has primarily been in the production area. The 64K RAM and the 256K RAM is their first attempt at threatening us in the technology area. And this is primarily due to the Japanese economy's ability to funnel these efforts in a very narrow focus with government support and government direction into certain companies to go ahead and develop technology as opposed to the competitive environment you have in the United States.

Senator **Chafee**. We were always taught that the competitive environment produced the best.

Mr. **Perlman**. It typically does. But you have the different outlooks of the governments which can either hamper the free enterprise or can aid it dramatically.

Senator **Chafee**. All right, gentlemen. Senator Dole.

The **Chairman**. I have no questions. I've been occupied in other meetings. I appreciate Senator Chafee chairing the hearing this morning. I probably will after I have had time to read this. I understand there is one who wants to expand industrial development bonds and we are trying to shrink them so I wouldn't hold out much hope for you.

Senator **Chafee**. Mr. Cherecwich, we have listened to a lot of testimony. And we have got five more witnesses, and I would be willing to bet that every single one of them is protesting against any change, certainly any increase, in the tax structure. I would be willing to take that bet pretty safely. No one here who has testified so far has volunteered any tax increase although Mr. Christrup got close to it.

Mr. **Christrup**. I will volunteer the safe harbor leases too, if you like.

Senator **Chafee**. Well, you will find a zillion people on the other side who will object to that. We had a strong panel here yesterday. That's all right. We expect that. But somehow to press industrial development bonds for the high technology industry, I think, is pressing the matter a little far, Mr. Cherecwich.

Mr. **Cherecwich**. May I make one statement with regard to completed contracts in conclusion, sir?

Senator **Chafee**. Well, yes, but I would make it brief because we have pretty well covered this area.

Mr. **Cherecwich**. SAMA member companies by and large are not users of the completed contract method. Both the administration's proposals would have a very serious impact. I think many people are not aware of the impact of the administration's proposals on nonusers of the completed contract method.

Senator **Chafee**. Why would it affect you? Take Foxboro.

Mr. **Cherecwich**. Take the Foxboro Co. We are on something called the "accrual shipments method" of accounting. And the administration's proposal would take any contract that hasn't been shipped over yearend, as I understand it, and require us to start using the progress payments method of accounting rather than the inventory methods of accounting that we have used for years. And even if the administration's legislative proposals fail, their administrative proposals would require us to turn around and change the methods of inventorying costs, which we have all used for years.

Senator **Chafee**. All right.

Mr. **Cherecwich**. And I just encourage people to be aware of that, sir.

Senator **Chafee**. Right. Well, I am glad you brought that out because we anticipated most of the objections to come from defense contractors and builders.

Mr. **Cherecwich**. I agree, sir, but this is a real sleeper for smaller companies.

Senator **Chafee**. Fine. Thank you.

The **Chairman**. I will just say that we are going to be working—the staff will be working, after they have read the statements, and will be looking for more input from many of the witnesses. I don't want to leave the impression that we are going to arbitrarily make up our minds, and we are not going to hold hearings until somebody volunteers to have their taxes increased either, but we hope to wind up the hearings this week and start voting on something in the next couple of weeks. So we won't make you suffer too long.

Senator CHAFEE. All right, gentlemen. Now we will take the other panel. Thank you very much for coming. We appreciate it. Now to the panel that was deferred.

The CHAIRMAN. This was deferred because Mr. Daniels is from my wife's home State and I wanted to be here for their testimony.

Senator CHAFEE. I've heard of the Jones Construction Co., Jones Construction, I believe, worked with Gilbain Building on a big project. I may be mistaken. Mr. Daniels, didn't you work with Gilbain in a joint construction project? I may be mistaken.

Mr. DANIELS. You probably are. I don't remember it.

Senator CHAFEE. You helped us on the 911 issue, I remember.

Mr. DANIELS. Oh, very definitely. And you helped us. And thank you.

Senator CHAFEE. Has it worked the way we thought it would work? Do you have more Americans overseas? Are you keeping them there?

Mr. DANIELS. Well, unfortunately, my company doesn't have as many contracts overseas as we had at the time we were pressing so hard but it has helped construction generally. And when we are successful in getting more work overseas, yes, sir, it will help us.

Senator CHAFEE. All right. Why don't we start alphabetically. Mr. Holleman, chairman of the Committee on Contract Accounting, National Constructors Association. All right, gentlemen, we've got half an hour for this panel. So whoever takes a lot of time in the beginning is just doing in his fellows at the end. So that gives you 5 minutes apiece; we will see how it goes.

Mr. HOLLEMAN.

STATEMENT OF WILBUR HOLLEMAN, CHAIRMAN, COMMITTEE ON CONTRACT ACCOUNTING, NATIONAL CONSTRUCTORS ASSOCIATION, WASHINGTON, D.C.

Mr. HOLLEMAN. Thank you, Mr. Chairman. Mr. Chairman and members of the committee, my name is Wilbur Holleman. I'm the chairman of the Committee on Contract Accounting of the National Constructors Association. This is 57 national contractors and subcontractors. We also have filed a very detailed statement.

Now I personally have 25 years experience in the taxation of construction companies, both as an outside attorney and currently as an executive. This particular committee we have in the NCA is a new committee because despite the announcements made last September, we didn't think the Treasury was after us. We have now found out that they are also after contractors. Despite the fact that we've had this method and used it for 64 years, and our taxes during that period have been consistently correctly computed and paid. Now there are differences between contractors and manufacturers. There are obvious differences. But in this field there is an enormous difference. They have been using it officially only since 1976, which is 6 years. We've been using it since 1918, which is virtually 65 years. And the reason is it is the natural and the historical method for us.

Now you say, well, 1918 that was a long time ago. Well, I'm happy to tell you that in 1976, as a result of a 6-year study, those regulations that govern contractors were studied jointly by Treasury and by industry and they were refined and updated. And so what we have is a historical natural accounting method that is up to date. I think we are really pretty rare in that respect.

The aerospace industry, really, I think their problem is they don't have a natural accounting method. They have got a lot of problems.

The completed contract method for us works very well. And it's proper because, one, you pay tax when your income is realized. You have completed your transaction. Second, you are at the point where you know how much you have made or how much you have lost. And, third, if there is retainage, as is customary, you've got the cash in your pocket upon completion to pay that tax.

Now the Treasury has some alternates, which I won't spend much time on. One of them is called percentage of completion. That is basically a system of estimates. And estimates may be OK for financial accounting or other purposes, but they are not right for tax liabilities.

They also have a new invention. They are creating a new accounting method in 3 months or less, despite everything else that is going on, called the "progress payment method." Now what it is is taxes cash flow. So in the one case you have got a system based on estimates, because they are saying let's use estimates. And the other one, even though you may not have the cash because of retainage. And in the other situation they say we have invented something. We, we are so bright, we've invented something that will take care of all the problems even though it taxes cash flow and not income.

Now at the same time they are coming in for legislation, they are also coming in for regulations. And these regulations, as has been mentioned before, effectively gut the method. They don't want to do that directly because they know the courts would say you can't take away something that has been around since 1918 directly. So they are trying to do it indirectly by some very complicated accounting regulations, but I assure you they gut and emasculate current law.

Now we, the construction and building industry, want to work with this committee and with the Treasury to curb any abuses. We are confident that those items listed in the Treasury report are not about the building and construction industry.

Senator **Chafee**. Would you name an abuse?

Mr. **Holleman**. Well, based on the Treasury report, they say that some of these contracts—they are not talking about us, I am confident—go on for 10, 15, even 20 years. They say that is too long. And I would tend to agree with that. Particularly, if, in effect, they are ever——

Senator **Chafee**. Suppose you are building a complex. You start out and you build one building. And then before you are through with that building, you put up another building. And then before you are through with that, another building. Is that one job? Or is that a series of jobs?

Mr. HOLLEMAN. It depends. If you have got a contract that says you build that complex, well, the only time you can tell whether you have made money or lost money with that complex is when you finish the whole complex.

Senator CHAFEE No; you get building A. It ends up that there are buildings A through H, but you start off with building A. And before you are through with that one, they give you a contract for building B.

Mr. HOLLEMAN. I agree, Senator. That's separate contracts.

Senator CHAFEE. Those are separate contracts. OK. Does that complete your statement?

Mr. HOLLEMAN. No; I just wanted to emphasize that we contractors, as historical users of this method—and as natural users—we are extremely concerned with the integrity of this method.

Senator CHAFEE. We have just got to wind up your statement—30 seconds more.

Mr. HOLLEMAN. OK. But I only need 7. It is so important for us because it is our traditional and our natural method. And we should not only be allowed to use this method, we should be encouraged to correctly compute our taxes.

Thank you.

Senator CHAFEE. Thank you very much.

[The prepared statement follows:]

STATEMENT
OF
WILBUR J. HOLLEMAN
CHAIRMAN OF
THE COMMITTEE ON CONTRACT ACCOUNTING
NATIONAL CONSTRUCTORS ASSOCIATION

BEFORE THE
SENATE FINANCE COMMITTEE
March 19, 1982

Mr. Chairman and Members of the Committee:

I am pleased to have the opportunity to appear before you today. My name is Wilbur J. Holleman, and I am Chairman of the Committee on Contract Accounting of the National Constructors Association ("NCA"). Our Association has represented many of America's large national construction companies for over 30 years. We presently have more than 50 member companies, who are engaged in building major process plants and related facilities for electrical power generation; oil refining, chemicals and petrochemicals; paper, mining, steel and metals production and fabricating; and other major process and manufacturing needs here in the United States and abroad.

When the Fall Budget Program was announced last September, the Treasury Department listed the "completed contract method" of tax accounting as one area under review "to eliminate abuses, remove obsolete incentives and enhance tax collections." We did not believe this review could conceivably affect our industry. Building and construction contractors have accurately and fairly computed their income and paid their taxes under the completed contract method since 1918. So far as we are aware the Treasury

Department has never before alleged that there are significant abuses in our industry or that our method of reporting constitutes an "incentive." The completed contract method is our industry's traditional and historic method for clearly reflecting our taxable income.

Thus, we were astonished when on February 18, just a month ago, a draft of the Treasury's proposals was "leaked" to the press, and we saw that we are a target of the proposals. The official General and Technical Explanation then appeared on February 26. Given the Treasury's own stated reasons for these proposals (discussed below), it is clear that the proposals should not apply to us.

We believe that, as applied to our industry, the long-standing Treasury regulations which authorize the completed contract method are correct and valid. If there are abusers in other industries who are improperly computing their income, we will support changes to preserve the integrity of the method. But the Treasury should not preempt Congressional consideration of this matter by unilaterally issuing proposed regulations which would effectively repeal the method by administrative fiat. Rather, the Treasury should present a legislative proposal and let Congress decide the matter. We are confident that once the true facts are understood, the Congress will retain the completed contract method intact for our industry.

The Treasury Proposals

The Treasury Department has offered a "two-track" proposal -- both legislative and regulatory. The legislation would abolish by statute the existing Treasury regulations, which without substantial change have authorized use of the completed contract method by our industry since 1918. See Reg. 33, Article 121 implementing the Revenue Act of 1917. In place of the existing method, taxpayers would have a choice between two alternatives, the so-called "percentage of completion" method and a newly invented "progress payment" method. Both of these alternatives are vastly inferior to the existing method, since they require a contractor to report income on a transaction at a point in time before it is possible to accurately determine whether or not there is income to report, i.e., at a time when no accurate determination can be made by anyone as to whether the contractor has a profit or a loss on his contract.

As the Treasury Department stated in a published ruling (Revenue Ruling 70-67) as recently as 1970:

> One of the reasons why permission to report on a completed contract basis is given in the case of building, installation, and construction contracts is the fact that there are changes in the price of articles to be used, losses and increased cost due to strikes, weather, etc., penalties for delay, and unexpected difficulties in laying foundations which makes it impossible for any construction contractor, no matter how carefully he may estimate, to tell with any certainty whether he has derived a gain or sustained a loss until a particular contract is completed.

The basic reason for completed contract accounting for construction is that it is the most accurate way of determining profit or loss for tax purposes from a specific contract. It is precise and meets the "realization" standard of tax law, which other methods do not.

The important issue at this point in time is that the Treasury has asked for legislation. We agree that if the method is to be changed or abolished, then Congress, not the Treasury, is the proper forum to judge the issue. The regulations have a long history, and the courts have therefore held that Congress has approved the method by re-enacting the governing statutory provisions. See, e.g., H. Stanley Bent v. Commissioner, 56 F.2d 99 (9th Cir. 1932). Treasury at this point is a contending party, and the regulatory process is not a proper way to resolve the matter. Taxpayers must rely on the Congress for basic fairness.

However, the second track of the Treasury's effort is to promulgate regulations which, as applied to our industry, would make the method completely unusable and would therefore have the effect, as a practical matter, of abolishing the method by unilateral, administrative fiat. We believe that such an administrative repeal would be legally invalid. Nevertheless, the Treasury is now writing proposed regulations which would revoke the method de facto by denying our industry current deductions for ordinary and necessary business expenses (such as pension contributions, interest on general corporate debt, corporate legal and accounting expenses, etc.) which every other industry in America takes for granted. This is patently unfair. Moreover, these proposed regulations, if issued, would usurp Congress's proper prerogative of reviewing this whole issue.

The legislative and regulatory proposals both have the same effective date, taxable years beginning after December 31, 1982. They represent over-lapping and redundant approaches: the legislation would render the regulations moot, and as to the construction industry, the regulations would make the legislation irrelevant since the method would already have been effectively repealed. Thus, we believe that one purpose of the Treasury's two-track maneuver is to unfairly coerce affected taxpayers into negotiating a compromise with Treasury on its proposed massive changes in the regulations. We submit that this improper tactic represents an abuse of the regulatory process by the Treasury. As far as the building and construction industries are concerned, the Congress must not let Treasury's efforts succeed.

Why is the Treasury making these proposals? Although we suspect the real reason is to raise revenues, regardless of the merits of the situation, the stated reasons are as follows:

First is "conformity." The Treasury Department believes the completed contract method does not conform to "standard accounting practices." This simply is not true. The method is a well-respected, long-standing approach, which the courts have sustained on numerous occasions. See *e.g.*, *James C. Ellis*, 16 B.T.A. 1225 (1929). Moreover, conformity with financial accounting methods has never been a determinative rationale in tax policy. As the Supreme Court recently stated in Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979): "A presumptive equivalency between tax and financial accounting would create insurmountable difficulties of tax administration." Financial accounting usually tolerates a range of "reasonable" treatments which are acceptable for book reporting purposes, but such a range of results is "questionable in a tax system designed to ensure as far as possible that similarly situated taxpayers pay the same tax." 439 U.S. at 544. Conformity between financial and tax reporting would simply create distortion and unfairness in the taxation of the construction industry.

Secondly, the Treasury explanation says that the completed contract method has led to large and unintended tax benefits. Several causes are mentioned. Treasury points to unjustified deferrals of the date of completion of a contract and combining the completed contract method with inventory accounting. Neither problem exists in our industry. If there are abuses in other businesses, we believe better audit enforcement, rulings and possibly some regulatory changes can deal with the problems, and we would support such actions. We note that manufacturers only began officially using the completed contract method in 1976. They simply do not have our 64 year history.

Finally, Treasury says, "Because of inflation and the increasing size of new contracts, the deductible costs will often exceed the income to be recognized (from old contracts) in any one year." Inflation affects us all. But the building, installation and construction industries have computed their income and have paid their taxes under the completed contract method since 1918, in times of inflation and times of deflation. We see no justification for repealing this accounting method because of transitory swings which may benefit the Government one year and some taxpayers the next year.

The economic effects of the Treasury proposals on our industry will be severe. The building and construction industry is a risky business even in the best of times. But today, many companies are on the edge of survival. Constructors often operate on limited capital, and imposition of a new regime of tax accounting, with all the attendant uncertainty and costs, will strain their financial resources. Many companies will lose their competitive ability, and some will not survive. Jobs in the building, installation and construction trades will be lost. The only people to profit will be lawyers and accountants, not the industry, not the Treasury, and not America's economy.

Legislative Proposal

The Treasury's legislative proposal would repeal the completed contract method altogether, and replace it with two alternatives -- the percentage of completion method or a newly invented "progress payment" method.

We strongly oppose this legislation. As described above, the traditional users of the completed contract method have paid their taxes fairly and equitably for 64 years. We see no reason to jettison that method now.

Moreover, the two replacement methods will not produce any better results, and most likely much worse ones. The percentage of completion method involves uncertainty and guesswork. The taxpayer must compute the ratio of costs incurred to date over estimated costs for the entire contract, and then multiply that ratio by the estimated gross contract price. Two out of the three factors are estimates and *per se* lead to disputes and litigation between taxpayers and the Internal Revenue Service. We note that under this method *all* costs are currently deductible.

Further, it is common for the owners of the facility to withhold retainage of say 10% of contract payments. The accumulated retainage usually is payable to the contractor only upon final acceptance of the work. Such retainage will often exceed the contractor's profit. Percentage of completion accounting gives no recognition to the adverse effect of retainage on the cash position of the construction contractor.

The new "progress payment" method departs from all traditional theories of income taxation, since it would tax positive net cash flow independently of current liabilities -- *it would not be a tax on profits*. The tax payments over the life of the job would bear no relation to either traditional tax or accounting profits. We wonder whether Treasury would regard the progress payment method, if it were used by a foreign country, as producing a tax on "realized net income," entitled to the credit for foreign income taxes under Temp. Reg. § 4.901-2(c)? Whatever the answer, it is strange that Treasury has lost sight of the importance of taxing only "income."

In addition, under this method taxpayers could not set off current losses on one contract against profits on another. Losses would be allowed only to the extent of gross income for the year on the specific contract in question. This is obviously unfair and arbitrary. Companies often knowingly enter into loss contracts as "loss leaders" for market penetration. Denial of these losses has no precedent in tax policy.

Further, construction contractors frequently use "front end loading" (e.g., mobilization payments) or unbalanced bids to minimize needs for contract financing. Later payments to the contractors are appropriately reduced. The Treasury proposal fails to allow for what is in effect an owner advance or loan to the contractor. Taxing such amounts would be wrong since they do not represent income.

The progress payment method is tantamount to taking a long trip in uncharted waters without even a compass. Treasury itself seems uncertain on the rules, and every day or two a new rumor surfaces as to what Treasury will propose. It is likely that no one would ever use such a bizarre method of computing tax liability (it does not compute income). Further, it could be inordinately expensive to develop and maintain records which could never be useable for any accounting purpose.

Finally, the progress payment method may simply constitute a recognition by Treasury that retainage in long-term contracts causes the percentage-of-completion method to impose tax on income that is not represented by cash so that the taxpayer may not be able to pay the tax. However, the progress payment method may be even worse than the percentage-of-completion method since it imposes tax on amounts that may not even constitute income under any existing accounting method. Thus, neither legislative proposal works properly or fairly when retainage is present, as is customary in construction contracts. Treasury must face the clear fact that the completed contract method is the only fair and correct way to handle retainage.

In sum, both these alternative methods have significant deficiencies. Neither is as good as the completed contract method for tax accounting purposes since only under this traditional method is tax imposed on realized amounts at a time when cash is available to pay the tax. There is no justification for repeal of the completed contract method and substitution of deficient alternatives.

Regulatory Proposal

Under the current Treasury regulations (section 1.451-3(d)), all "direct material costs and direct labor costs must be treated as costs properly allocable to a long-term contract." In addition, most indirect costs "which are incident to and necessary for the performance of particular long-term contracts" must also be allocated to the contract. These direct and indirect costs are deductible only when the gross income from the contract is included in income, *i.e.*, in the year the contract is completed. The present regulations list 14 classes of indirect costs which cannot be deducted currently. These costs include repairs, maintenance, indirect labor costs including some fringe benefits, financial depreciation, administrative costs and officers salaries which are attributable to particular long-term contracts, etc. It is essential to understand that substantially all costs of performing a contract are allocated and deferred; they are not deducted currently.

General company expenses, however, which benefit the taxpayer's activities as a whole, or have been the subject of special Congressional action, are not required to be allocated to particular long-term contracts, but instead are deductible when incurred. These so-called "period costs" include marketing and selling expenses, interest, research and development costs, general administrative expenses (but not overhead specific to a particular contract), pension contributions and other items.

The Treasury proposes to drastically revise the existing regulations by requiring that nearly all indirect costs be allocated to long-term contracts (i.e., "capitalized") and deferred until the contracts are completed. The proposal states that the new regulations will require that "all indirect costs that directly benefit the performance of long-term contracts and an appropriate part of all other indirect costs must be allocated to long-term contracts." This statement indicates that some "appropriate part" of indirect costs must be deferred, even if such costs do not directly benefit the performance of the contract. This is a massive change from existing law under which indirect costs that benefit specific contracts are generally deferred, but those which benefit the taxpayer's activities as a whole are deductible.

The proposal provides a limited list of items which are excepted from the general rule of deferral. No rationale is given for including or excluding various costs. Comparing the proposal to the current regulations, it appears that the following indirect costs which are now deducted will have to be capitalized:

1. Marketing, selling and advertising expenses other than "general marketing, selling and advertising."

2. Bidding expenses incurred in the solicitation of contracts which are awarded to the taxpayer.

3. Distribution expenses (other than marketing, selling, bidding and advertising).

4. Interest.

5. General and administrative expenses attributable to the performance of services which benefit the taxpayer's activities as a whole (such as payroll expenses, legal and accounting expenses, etc.).

6. Research and experimental expenses directly attributable to particular long-term contracts in existence at the time such expenses are incurred or incurred under any agreement to perform such research or experimentation.

7. Percentage depletion in excess of cost depletion.

8. Depreciation and amortization reported for Federal income tax purposes (i.e., ACRS depreciation) in excess of depreciation reported by the taxpayer in his financial reports.

9. Qualified pension contributions to the extent they do not represent past service costs, and profit-sharing contributions and other employee benefits incurred on behalf of labor, including workmen's compensation, non-qualified pension and profit-sharing contributions, premiums on life and health insurance, and other miscellaneous fringe benefits, such as medical treatment, cafeteria and recreation facilities, etc.

10. Costs attributable to rework labor, scrap and spoilage.

11. Compensation paid to officers attributable to the performance of services which benefit the taxpayer's activities as a whole.

We believe the existing regulations correctly treat those eleven items as deductible period costs. Existing law allows both contractors and manufacturers to deduct two narrow categories of indirect expenses: (1) costs which are not attributable to specific contracts and are therefore not susceptible of allocation to a particular contract, such as general administrative expenses, interest and salaries of officers not working on specific contracts, and (2) costs for which Congressional policy favors immediate tax benefit, such as accelerated cost recovery (ACRS) in excess of financial depreciation, pension and profit sharing contributions and research and development costs. The determination of these "period" costs for current deductions reflected careful deliberation by prior Treasury officials over a six year period (1971-76). Each of them is as justified for the construction contractor as for the typical manufacturer.

The category (1) expenses in question are incurred on a regular, periodic basis, irrespective of whether the taxpayer is performing one, several or no long-term contracts during the particular period in question. Realistically, these expenses simply do not contribute to the performance of a particular contract, and they do not add value to the subject of the contract; rather, they relate to the taxpayer's business as a whole. These everyday expenses cannot be traced to particular contracts, nor would it be proper to allocate them among contracts based on some arbitrary, pro rata formula. Accordingly, current deduction is necessary in order to clearly and accurately reflect the taxpayer's income. There is no justification for attempting to capitalize ordinary and necessary business expenses.

For some of the items, it could perhaps be argued that in the most theoretical sense allocation is possible, albeit arbitrary; but even as to these items, attempting an allocation would be extremely impractical and imprecise. Complex and lengthy regulations will be needed. Large accounting and legal fees and costly record-keeping and paperwork burdens will be imposed on taxpayers, most of whom in the building and construction businesses are small companies operating on slim margins. Unnecessary and unproductive disputes and litigation will be the only possible result. The Treasury Department has not yet found a reasonable way to avoid the significant administrative difficulties which this proposal will cause, and we believe it will be unable to do so. If it does find a way, it should apply equally to manufacturers and companies which self-construct projects, not just to construction contractors.

With respect to the category (2) expenses, the Congress has itself specifically determined that these expenses should be deductible and not be capitalized or deferred. As described below, the Internal Revenue Code expressly permits deductions for interest, research and development costs, pension contributions and other items in the Treasury proposal. Where these items are not to be currently deductible, the Congress has legislated specifically. See, e.g., Code Section 189, concerning capitalization of construction period interest and taxes. Denying deductions for these costs by administrative regulation would, in effect, amend these explicit statutory provisions and countervene Congressional approval of the historic treatment of these common business expenses.

Finally, this regulation proposal is extremely unfair and inequitable, in that it would impose these improper and unworkable regulations on construction contractors, while leaving manufacturers of goods free to continue to deduct period costs. The proposals would be in total conflict with the inventory capitalization rules. See Reg. § 1.471-11. Every expense which is to be capitalized by contractors under the Treasury proposal may be currently deducted by the typical manufacturer, as well as by persons who construct their own assets rather than contracting the work out. The proposal thus would create a tax-law bias against contractors. The existing regulatory treatment of period costs was finalized by Treasury in 1976, for the purpose of "essentially restating the costing rules found in case and ruling authority." 41 Fed. Reg. 2636 (January 19, 1976). Equal treatment of contractors, owners who self-construct and manufacturers of goods was a prime regulatory goal, which in large measure has been achieved. We cannot believe that conditions have so drastically changed since 1976 as to justify this proposed major policy reversal by Treasury.

In the light of these overall policy considerations, each item in the proposed list requires separate analysis.

1. "Non-general" marketing, selling and advertising. Marketing, selling and advertising are all ordinary and necessary expenses of doing business on a daily basis. By carving out "non-general" expenses, the proposal apparently attempts to require capitalization of costs which are somehow directly targeted or traceable to a particular contract.

Both conceptually and practically, this approach cannot be justified. The basic reason is that it is impossible to find a clear nexus between a particular marketing cost and a particular contract: the cause and effect relationship simply cannot be demonstrated with any reasonable accuracy. For example, marketing or advertising directed at the particular needs of one group of potential customers cannot be sensibly allocated to the contracts which may or may not result. Much of the cost of any advertising campaign should probably be treated as a deductible loss in any event, since many potential customers never become actual customers. Further, the campaign will have unintended "spill-over" effects which are unrelated to the main effort; for example, the campaign may produce contracts with untargeted customers. How is any relationship to be determined? Moreover, a marketing program developed in connection with one effort will undoubtedly be used again and again at little additional marginal cost. Attribution of the initial costs solely to the first contracts produced would not be as logical as current expensing of the costs.

Thus, tracing of advertising costs to individual contracts is impractical, and pro rata allocation on some other basis (such as "expected" gross revenues or "expected" net profits) would involve distortion, unfairness and guesswork. The Treasury Department has not indicated how allocation would be accomplished, nor how costly litigation would be avoided. In sum, it has not justified its proposal.

2. Successful bidding costs. In a theoretical sense, the cost of preparing a bid on a contract which is awarded to the taxpayer might be viewed as an acquisition cost of the contract. However, the Internal Revenue Service has itself rejected this view. In Revenue Ruling 56-136, 1956-1 C.B. 92, the Service considered the proper treatment of commitment fees or standby charges incurred by a taxpayer for the purpose of having credit made available when needed in connection with a construction project and preserving a firm price and interest rate for funds to be borrowed. The ruling holds that such costs are deductible business expenses in the nature of carrying charges, which may be deducted under Code section 162 or, at the election of the taxpayer, may be capitalized as part of construction costs. Such commitment fees are closely analogous to bidding expenses incurred in successful contract solicitations; in both cases, the costs are incurred for the purpose of obtaining a contract at a fixed price.

But even if there is a theoretical basis for allocating bidding expenses and the Treasury now wants to take a different view, in reality there is no consistent or acceptably precise way to do so. It is rare indeed that the expenses incurred in preparing a bid can be neatly or easily segregated and allocated to that bid. For example, the engineering and technical work which goes into a particular bid may have been done in a prior period in connection with several other projects or as part of the taxpayer's activities as a whole. The expertise of a professional construction engineer, for example, has been built up over a lifetime of different work. As in the case of marketing and advertising, allocating bidding costs to particular contracts is unrealistic and unworkable.

3. Distribution expenses. "Distribution" generally refers to certain expenses of manufacturers of goods rather than builders or construction companies: traditional contractors normally have nothing to "distribute." Yet manufacturers will be allowed to continue deducting their distribution costs. Moreover, even in the few cases where a contractor engages in distribution, it is very difficult to distinguish "distribution" from general marketing, selling, advertising and bidding. It is entirely unclear what the Treasury has in mind and why these vague and uncertain lines are being drawn.

4. Interest. Interest, which constitutes a charge for the use of money over a particular period of time, is the very essence of a period cost. The law is crystal clear that mandatory capitalization is improper. Section 163 provides specific authority for the deduction of interest, and section 266 provides that carrying charges, such as taxes and interest, may be capitalized only under limited circumstances at the

election of the taxpayer. The section 266 regulations recognize that interest is "otherwise expressly deductible," under section 163, and therefore that enactment of section 266 was needed in order to permit elective capitalization.

The Treasury's own proposal is inconsistent on this point. On the one hand, the Treasury is attempting to require capitalization of interest, in the case of construction contractors, by administrative regulation. On the other hand, it recognizes that capitalization of construction period interest by the corporate owner of a project can only be required by statutory amendment of section 189. If capitalization is statutory for owners it should similarly be statutory for contractors. Congress would certainly not wish to legislate discriminatorily for one group, but let Treasury rule on its own for the other group.

Moreover, we believe it would be entirely impractical to attempt to allocate interest to particular contracts, except in the rare case where the interest is a cost of performing a specific contract. The Treasury Regulations under section 861, dealing with allocation of deductions to U.S. source income, state that interest normally "relates more closely to the amount of capital utilized or invested in an activity or property than to the gross income generated therefrom, and therefore the deduction for interest should normally be apportioned on the basis of asset values." Reg. § 1.861-8 (e)(2)(v). Costs in excess of billings on construction contracts are recorded on the balance sheet but are not assets in any real sense. Other assets used by a contractor -- such as machinery and equipment -- would be a very unreliable indicator, since labor is usually the principal component of construction costs. Moreover, the section 861 rules are exceedingly complex and difficult to understand (they took a decade to develop), and application of these rules to thousands of construction contractors would create massive administrative problems.

How then would interest be allocated under the Treasury's proposal? Allocation based on "estimated" or "reasonably expected" income obviously could not be used, since the basic rationale for the completed contract method is that income or loss cannot reliably be determined in advance of completion. In any case, if an allocation method is proposed, we believe that taxpayers must be permitted to trace borrowed funds to particular uses, as an exception to any general allocation method. For example, if a taxpayer incurred debt for the specific purpose of acquiring a subsidiary company not engaged in the construction business, then interest on that debt should be treated separately and remain currently deductible.

Moreover, there is the significant problem of treating parent-company debt in a controlled-group context. The section 861 rules are applied on a separate company basis, presumably because Treasury could find no reasonable way to "look-through" a complex corporate structure. How does Treasury propose to allocate parent-company debt to third-parties and intra-group debt between affiliated companies?

Finally, how will Treasury deal with borrowing in foreign currencies? If interest is to be capitalized, companies may prefer to borrow Swiss francs, for example, with a low stated interest rate, as compared with British pounds, with a high rate. The difference in rates is usually made up by exchange gains or losses on repayment. How will exchange gains or losses be treated? Treasury has not yet been able to settle on a policy in this area after decades of consideration and would only be compounding uncertainty and administrative problems.

5. General and administrative expenses. Like marketing and interest costs, general and administrative expenses conceptually do not contribute to the completion of particular contracts; instead, they are necessary to the business as a whole, regardless of the particular contracts currently in progress. Administrative costs which are specific to a particular contract are already capitalized under the existing regulations.

As a practical matter, capitalization of general expenses cannot be reasonably accomplished. For example, how are the legal costs of general corporate housekeeping, such as writing the corporate minutes, to be allocated? How does one allocate the expenses of say an outside cleaning service which cares for the floors in the company's building? Clearly, the difficulty of the answers swallow up the question. And the unfairness is patent: Why are contractors being singled out to capitalize general and administrative expenses which every other business in America deducts without a second thought?

6. Research costs. Here too, allocation is impractical, if not impossible. Section 174 of the Code was enacted for the very specific reason that it was impossible to properly segregate and capitalize R&D in any context, and therefore complete deduction was needed. Why does Treasury believe capitalization will be any easier, or any fairer, as to long-term contracts compared with patents, self-constructed building projects, manufacturing, etc.? For example, suppose a construction and engineering company does research into the strength of certain metals to be used by it generally. A particular contract then is begun which requires special purpose metals, derived from the prior research. How will the research expenses be allocated?

In addition, capitalizing R&D would significantly impair the effectiveness of the R&D incentive provisions enacted in 1981, i.e., the R&D credit, exclusive domestic sourcing of R&D expenses and faster ACRS depreciation for R&D equipment. Moreover, the Congressional decision to end allocation of R&D expenses to foreign sources was based both on the incentive aspects and on the realization that the section 861 sourcing rules are complex, difficult to administer and often arbitrary. Why is the Treasury now attempting to reverse the thrust of 1981 policy in this very important area for national growth? Why are contractors being put at a competitive disadvantage vis-a-vis manufacturers?

7. Percentage depletion. It is difficult to say what Treasury has in mind here. We do not believe either percentage or cost depletion normally enters into contract work in any material way. Treasury may not approve of percentage depletion, but this is not the way to deal with that broader issue.

8. Accelerated depreciation. The centerpiece of the Administration's 1981 business tax cut program was, of course, the Accelerated Cost Recovery System (ACRS), which significantly increased incentives for capital investment while greatly simplifying record-keeping and reducing disputes between taxpayers and the Internal Revenue Service. Now the Treasury proposes in effect to repeal ACRS for contractors, but not for other taxpayers, including manufacturers and those who do their own construction. Capitalization of ACRS accelerated depreciation will reduce investment and increase paperwork burdens. For whatever new equipment contractors do purchase, detailed records and complicated cost-accounting will be needed. If the Treasury believes ACRS is too generous (which we doubt), then it should scale it back on an even-handed basis for all taxpayers alike.

9. Pension contributions and other fringe benefits. Pension and profit sharing contributions have been recognized as legitimate period deductions for many years. For example, the Internal Revenue Service's ruling in I.T. 3408, 1940-2 C.B. 178, which authorizes pension deductions in connection with self-constructed assets, has been in effect for 42 years. Moreover, in its brief to the Supreme Court in

Commissioner v. Idaho Power Co., 418 U.S. 1 (1974), the Government admitted that pension costs which were specifically deductible under section 404 should not be capitalized. The Supreme Court agreed. See 418 U.S. at 17.

Fundamental national policy issues are at stake. The Code and ERISA contain complex, detailed rules for regulating and encouraging private pension plans. The rules regarding funding levels and benefit amounts are precise. These rules, built up over many years, are based on the premise that contributions are currently deductible. To eliminate current deductions for only one group of taxpayers is patently unfair and completely contrary to the thrust of many decades of pension policy.

The Treasury proposal would permit deduction of "past service" pension costs, but not of "current service" pension costs, all profit-sharing costs and related fringe benefits. The distinction between past and current service has no relevance to long-term contracts. The past service amount is the total amount of funding which an actuary would have required to be in a plan to date had the plan always been in existence in its present form. That amount is then amortized over a period of years (usually 30-40). Current service cost on the other hand is the annual contribution which an actuary says would be necessary if the plan had always been in effect.

How can Treasury possibly use these difficult concepts to provide a fair and understandable allocation system? The fact is that pension contributions for any year fund benefits for employees for past years, the current year and for future years in order to provide a specified pension. Moreover, the contributions must be made without regard to how many contracts are in progress or which employees are working on which contracts.

Finally, assuming that contributions are made currently (the only reasonable assumption), but not deducted during the life of a contract, how will Treasury treat the "bunching" of deductions in the year the contract is completed? A large deduction in the last year could easily violate the section 404 limitation of 25 percent of compensation. Indefinite carryforward means indefinite deferral of the deduction. This will create a strong disincentive to maintenance of private pension plans in the building and construction industries.

Similar problems arise as to other fringe benefits covered by the proposal. The results approach the absurd. For example, how will Treasury allocate to particular contracts the cost of a company cafeteria or recreational facilities? Will employers be required to keep daily records of which employee ate in the cafeteria or played softball on a company-provided field, how much he or she ate and the cost (or perhaps value?) of the benefit conferred? Why should construction contractors bear accounting and administrative burdens that no one else does?

10. Rework labor, scrap and spoilage. We do not understand Treasury's concern in this area. Spoilage of materials, for example, is often a company-wide problem which rarely affects a particular contract.

11. Officer's compensation. It is rare that upper level officers work on a specific contract, but if one does, the current regulations clearly require allocation to that contract and prohibit a current deduction. It is, however, difficult to justify allocation of compensation "attributable to the performance of services which benefit the long-term contractor's activities as a whole." For example, how can the salary of the Vice President for Taxes be allocated to specific contracts? His work involves corporate tax-planning and tax return preparation for the company as a whole. Will an hourly diary be required? We submit that any proposed allocation method will be arbitrary and unworkable. The fact of the matter is that the officers generally work for the betterment of the company as a whole and do not contribute to the performance of any particular contract.

In sum, the present period cost regulations are well thought out, consistent and, in a word, correct. It certainly is not for the Treasury Department or the IRS to implement unworkable allocation rules, existing accounting rules are complex enough. Further, Treasury should not be permitted to frustrate Congressional policy with respect to ACRS, R&D, etc. The Treasury regulation proposals can perhaps best be characterized as theories running amok in the blind pursuit of revenue.

This is not to say that existing regulations should not be expanded upon with respect to matters other than period costs, more particularly that rulings amplifying aggregation of contracts or when a contract is completed should not be issued by IRS. If there are abuses, however, period costs are not the problem -- they are logical, reasonable and reflect existing precedents, and they should be left as they were officially worked out in 1976. Nor is completed contract accounting for construction contractors a problem -- it is logically justified and is the best method for arriving at profit or loss from a given contract. It is a method that has integrity for tax purposes because it ensures that only true income will be taxed and that cash will be available to pay that tax.

Conclusion

In summary, we do not believe the Treasury Department should take preemptive action by issuing proposed regulations while this issue is before the Congress. There is no policy justification for departing from the 1976 regulations so far as period costs of the construction industry are concerned, and the administrative problems would be immense. The proper forum at this time for resolution of the issues which Treasury has raised is the Congress.

Our industry will be happy to work with the Congress as it considers this important matter. We, as much as Treasury, want abuses corrected. We, and apparently not the present Treasury, strongly believe in the integrity and correctness of the completed contract method, and we believe that, if necessary, it must be fixed so that it can be retained for us, its traditional users.

We would also urge caution about the revenue aspects of Treasury's proposals. We note the article on page 1 of the March 2, 1982 Washington Post which concludes that the 50% of the estimated increased revenue from ending completed contract accounting attributable to defense contractors "would be largely illusory. . . in that the affected contractors would be able to pass along the higher costs just as they do other costs." If this is so, and we are in no position to know, then the construction industry, for whom this tax accounting method was designed, will be virtually alone in bearing the costs of this dramatic change in law after 64 years. It would be grossly unfair to add to the burdens of the construction industry in troubled economic times, when many firms are fighting to survive.

The National Constructors Association believes that members of this Committee should ask the Treasury Department to desist from its unilateral attempt to abolish the completed contract method by making massive and improper changes in its own tax regulations. Further, we hope we have convinced this Committee that our industry reports its income and pays its taxes as accurately and fairly as any other industry. Whatever the exigencies of the situation with respect to the need to raise revenues, there is no justification for discriminatory treatment of the construction industry.

STATEMENT OF JOHN S. NOLAN, ON BEHALF OF THE AEROSPACE INDUSTRIES ASSOCIATION, WASHINGTON, D.C.

Senator **Chafee**. Mr. Nolan.

Mr. **Nolan**. Thank you, Mr. Chairman. My name is John S. Nolan. I appear today for the Aerospace Industries Association in strong opposition to the Treasury Department's proposals, both in regulations and proposed legislation, with respect to the completed contract method.

The Treasury proposals go well beyond an effort to repeal the completed contract method of tax accounting. They seek to impose an ill-conceived, radical, new tax accounting method on the construction, shipbuilding, heavy equipment, and aerospace industries whether or not the particular company involved has been using the completed contract method. They seek to deny to these industries the traditional use of the accrual method of accounting available to all other business taxpayers. They seek to tax cash flow rather than income, a drastic concept which would reject all accounting principles and raise constitutional questions under the 16th amendment.

These proposals will create extraordinary new inequities, complexities, uncertainties, litigation, and administrative difficulties in the income tax system for business taxpayers. This is completely unnecessary, and the Treasury proposals should be rejected by this committee.

The Treasury Department should be immediately instructed not to issue any proposed regulations until the matter has been studied by this committee. Treasury should ultimately be instructed to revise the regulations to eliminate any undue benefits in the completed contract method, but to preserve its existence. Treasury should be advised to amend the regulations to achieve greater consistency with the regulations governing accrual basis taxpayers with inventories.

The Aerospace Industries Association has suggested a number of constructive changes to the Treasury Department, and is prepared to cooperate further in improving the regulations. This process will result in some significant revenue gains for the Federal Government, and will also result in greater equity, simplification, and ease of administration of the tax laws.

The **Chairman**. Do I understand that if there are gains made, you just pass those onto the Defense Department, and if you pay more tax, then you charge the Defense Department more?

Mr. **Nolan**. Well, that's a matter of negotiation with respect to each contract—that is, how much profit is going to be allowed with respect to the contract. You don't pass along your taxes, your income taxes, as a cost to the Government. That is a factor that affects your profit.

The **Chairman**. If we changed the completed contract method by regulations and by law, some have suggested that that change wouldn't bother defense contractors, they would pass on the income tax cost to the Government in another way. Maybe that is a legitimate way to handle defense contracts. I don't know.

Mr. **Nolan**. Well, it's necessarily true, Senator, that in the case of an industry that is only earning about 3.8 percent on sales, generally, if you increase their income taxes, they are going to have to ask for larger profits on their defense contracts. It follows that defense prices are going to go up as a result of this.

The CHAIRMAN. Does that count as a cost overrun? That's the biggest entitlement program I know.

Mr. NOLAN. Cost overruns will depend on what the cause of the cost overrun was. If it was attributable to changes that the Government made in the scope of the contract, they have to be paid for. If it was not attributable to that, if it was attributable to inefficiencies, the contractor does not get paid for those amounts.

Now everyone is deeply concerned about the complexity and inequities in our tax system. The Treasury Department, however, in a desperate effort to propose new revenue enhancers has jumped upon the defense industry and a few other industries which are politically vulnerable to propose massive new tax burdens on these industries in the ever popular name of closing loopholes or tax reform. The Treasury proposals are not well thought through and will do structural damage to the tax system. The progress payment method of accounting will create enormous new complexities both for large and small business and will cause serious new inequities.

The Treasury Department also seeks to increase the tax burden on the aerospace industry still further through the corporate minimum tax proposals. Thus, the Treasury would impose the minimum tax with respect to contracts entered into by the industry in prior years. This would impose a substantial added financial cost on the defense and construction industries.

These multiple financial burdens that the Treasury Department proposals focused upon the aerospace industry could do substantial harm to our national defense. As I said, the industry is already earning an average of only 3.8 percent on sales with the benefit of the completed contract method. It cannot afford the crippling financial burden that would result from withdrawal of the method. The Treasury proposals could easily raise the cost of national defense more than they would produce in added tax revenues. And in the process, they would seriously disrupt the capital planning of this vital industry. This makes no sense whatsoever at a time when we are seeking to induce our major industries to modernize and expand their facilities.

The Congress is deeply concerned about projected triple digit deficits over the next 3 years, but this cannot justify adoption of an ill-conceived new tax burden on the construction and aerospace industries. This is particularly so when the change would do serious harm to the structural integrity of the tax system, would cause severe new inequities and complexities, and would do serious damage to our national defense.

I strongly urge you to reject the Treasury proposals and proceed as I have suggested.

Thank you.

[The prepared statement follows:]

STATEMENT OF JOHN S. NOLAN ON BEHALF OF
THE AEROSPACE INDUSTRIES ASSOCIATION
BEFORE THE SENATE FINANCE COMMITTEE
MARCH 19, 1982

COMPLETED CONTRACT METHOD

My name is John S. Nolan. I have thirty-five years of experience in tax practice in the accounting and legal professions, including particularly tax accounting methods.

I appear today for the Aerospace Industries Association in strong opposition to the Administration's proposals with respect to the completed contract method. These proposals actually go well beyond an effort to repeal the completed contract method; they seek, in effect, to impose an ill-conceived, radical new tax accounting method upon all businesses delivering products to the customer's specifications under contracts extending over more than one year. This new method, which the Treasury calls the "progress payment method", will cause extreme hardship to the construction, shipbuilding, heavy machinery, and aerospace industries. The proposal would create enormous uncertainty as to the tax reporting of these industries; result in extraordinary, new complexity in the tax laws; cause severe tax administration difficulties for the Internal Revenue Service; and produce major inequities in the treatment of similarly-situated business taxpayers.

The Administration's proposal should be rejected by this Committee. The Committee should direct the Treasury Department to reconsider the regulations dealing with "long-term contracts" and improve their application in light of experience gained over the last ten years. The Aerospace Industries Association has suggested a number of specific improvements to the Treasury Department in written and oral communications over the last several months. The Treasury Department should be immediately advised not to publish any proposed regulations until the issues involved have been considered by this Committee. Following such consideration, the Treasury Department should be clearly instructed to preserve the completed method but to revise the regulations to eliminate any undue benefits but in a manner entirely consistent with the regulations governing accrual basis taxpayers maintaining inventories. This consistency will result in much greater equity, simplicity, and ease of administration among business taxpayers. In the process, it will result in some significant revenue gains for the Federal Government.

The following analysis sets forth -- (a) the reasons for use of the completed contract method, particularly in the aerospace industry with its unique profit or loss uncertainties and tax reporting difficulties; (b) the extraordinary, adverse impact that denial of this tax accounting method would have upon our national defense; and (c) the fundamental fallacies in the Treasury's proposed new "progress payments" tax accounting method and the severe inequities, uncertainties, and complexities it would create.

I. SUMMARY

The completed contract method of tax accounting is predominantly used for federal income tax purposes in the construction, shipbuilding, and aerospace industries. This occurs because in these particular industries, there are extraordinary uncertainties as to profit or loss, which are determinable only as contracts are completed. Further, there is no other reasonable method of tax accounting for determining taxable income in these industries; any other existing method requires the use of uncertain estimates of receipts and costs.

Use of the completed contract method was extended to manufacturing businesses with contracts extending over more than one year in regulations proposed in 1971. This extension was the result of consultations by several industries, including the aerospace industry, with the Internal Revenue Service, the Treasury Department, and the Staff of the Joint Committee on Taxation. The conclusion of the Internal Revenue Service and the Treasury Department in 1971 to clarify the use of the completed contract method took into account the extensive litigation that had occurred as to proper tax accounting methods for industries such as aerospace, shipbuilding, nuclear plant construction, and commercial construction. Some companies in these industries had been permitted to use the completed contract method; some had not. Those using the completed contract method were not experiencing the difficulties of those not using it. Some companies had sought to deduct losses in the early stages of long-term contracts; others, using the completed contract method, could not do so. The objective of the changes reflected in proposed regulations in 1971 was to resolve the resulting uncertainties on a balanced basis that protected the interests of both the Government and these industries.

As a result of these actions, virtually all members of the aerospace industry sought and received permission on an individual basis from the Internal Revenue Service to use the completed contract method. Various conditions were imposed by IRS to safeguard its interests, such as limiting the use of carrybacks, and these conditions were accepted by the industry.

The method has now been used by most members of the industry for periods from five to ten years. The resulting deferral of tax liability in the industry, and consequent effect upon its cash position, has been taken into account in determining acceptable profit rates and progress payment needs in its contracts, and thus in the pricing and negotiation of contract terms for the great majority of the industry's products. A withdrawal or substantial curtailment of the existing use of the method would seriously cripple this industry's capacity to provide for the critical defense needs of the United States.

The short-term revenue gain to the Treasury Department from withdrawal or substantial curtailment of the use of the completed contract method by the aerospace industry would be significantly limited by the effect of essential transition rules. The Treasury's proposed transition rules are unfair because they would treat the transitional adjustment, in effect, as a tax preference for purposes of their proposed new corporate minimum tax. This would substantially reduce the transitional relief.

The long-term gain of the Treasury's proposals would be extremely uncertain because of the unique tax accounting difficulties in this industry. There would be little revenue effect in the 1983-1985 budget period.

It is unfortunately more likely that there would be a return to the uncertainty which formerly existed and the litigation which prevailed. The same is probably also true in the case of the construction, shipbuilding, and other industries using the completed contract method of accounting where there is a high degree of uncertainty as to the realization of profit or loss until particular contracts are completed.

The Treasury Department seeks to avoid these uncertainties by proposing the required application of a new tax accounting method first described by them on February 26, 1982. This method, the "progress payment method", has no antecedent in the seventy years of history of our income tax system and would be completely rejected by the accounting profession. It has startling attributes which even raise Constitutional questions -- such as attempting to tax borrowed funds as income, denying the taxpayer the right to offset losses on some contracts within a single business against profits on other contracts in the same year, and denying the taxpayer the right to offset a loss on a contract in a later year of its performance against profits erroneously required to be reported on that same contract in an earlier year.

In addition, the Treasury would require this new progress payment method to be used for long-term contracts _whether or not the taxpayer would otherwise have used the completed contract method_. Thus, Treasury seeks to deny to all businesses with long-term contracts the use of the traditional accrual method of accounting and to impose harsh, new cost allocation rules on these businesses which are completely unworkable and inequitable. This proposal must be rejected; it will cause unprecedented uncertainty for business taxpayers and result in endless litigation. Businesses will be forced to attempt to revise their ordinary business practices so that their contracts are not "long-term contracts" so that they can obtain the same tax treatment as all other business. Small businesses will be faced with an entirely new set of extremely complex tax problems.

This major change in the tax accounting treatment of business taxpayers is unnecessary. There are some problems in the use of the completed contract method for tax purposes; ten years' experience with the substantial changes in the regulations proposed in 1971 have brought these problems to light, as would be the case in any such important change in regulations. The Aerospace Industries Association itself has brought many of these problems to the attention of the Treasury Department over the last several months and has made constructive suggestions for specific improvements. Many of these changes will result in significant revenue increases. Most importantly, however, any changes in the regulations must treat all business taxpayers evenhandedly. Businesses with long-term contracts cannot be more harshly treated than accrual basis taxpayers with inventories of goods not manufactured to the buyer's specifications -- i.e., shelf items, such as steel shapes, automobiles, television sets, or any standard manufactured products, whether producer goods or consumer goods.

II. THE COMPLETED CONTRACT METHOD

A. Historical Background. The completed contract method of tax accounting has been sanctioned by Treasury Regulations since 1918. 1/ In subsequent years, substantial controversy developed over the use of estimates in determining income and in the treatment of advance or progress payments for goods to be delivered in the future, issues which particularly affected the construction, shipbuilding, and aerospace industries. 2/ The possibility of large losses on long-term contracts by manufacturers using the accrual method

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1/ Reg. 121, §33. The courts upheld the application of these regulations in early cases such as *Badgley v. Commissioner*, 59 F. 2d 203 (2d Cir. 1932), and *James C. Ellis*, 16 BTA 1225 (1929).

2/ See Schneider, *Tax Accounting for Contractors: Planning Under the New Regulations*, 35 N.Y.U. Ann. Inst. 29, 31-36 (1977).

of tax accounting led these manufacturers to seek loss deductions under the lower-of-cost-or-market inventory convention available to accrual basis taxpayers, and the courts allowed these losses. 3/

Many controversies also developed between the IRS and the aerospace industry as to the use of the accrual method. For financial accounting purposes, the industry to a substantial degree averaged its cost of sales upon deliveries over the entire number of units under a defense contract, or commercial airplanes under a "program" to build a given model. This reflected the fact that the construction of the initial airplanes, missiles, or space vehicles results in a much higher unit cost than subsequent units. Direct labor costs in this highly labor-intensive industry reflect the intricate fabrication and assembly of hundreds of thousands of individual parts or pieces for any unit. These direct labor costs follow a "learning curve" as production proceeds from one unit to the next under the contract or program. Material costs reflecting spoilage, and tooling costs to some extent, follow the same pattern. The product is priced under the defense contract or commercial airplane program on a unit basis which

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3/ Space Controls, Inc. v. C.I.R., 322 F. 2d 144 (5th Cir. 1963) rev'g and rem'g 21 TCM 295 (1962); E. W. Bliss Company v. United States, 351 F. 2d 449 (6th Cir. 1965). See also St. James Sugar Co-op, Inc. v. U.S., 643 F.2d 1219 (5th Cir. 1981). In Rockwell International Corp. v. Commissioner, 77 T.C. __, No. 57 (Oct. 13, 1981), the Tax Court denied such an inventory write-down for the taxpayer's fiscal year ending September 30, 1969. The taxpayer is expected to appeal to the Third Circuit.

reflects an averaging of these major costs, and financial accounting often follows the same concepts to determine profits or losses as units are delivered.

For tax purposes, however, the initial high level of costs of units delivered could be deducted on the accrual basis as deliveries of these initial units occurred. The costs had been actually incurred. At the same time, these abnormally high costs, which would result in large losses if deducted, would normally be recovered in the price of units to be subsequently delivered under existing contracts. Some companies deducted the high costs attributable to the initial units as they were delivered. Other companies followed their financial accounting treatment and averaged their costs over their defense contracts or commercial airplane program on a contract-by-contract or program-by-program basis. This averaging, however, necessarily involved the estimation of future costs of production under the contract or program in determining the costs to be deducted on the delivery of the early units.

The Internal Revenue Service was unhappy with either alternative -- one involved the deduction of losses that could be said to be unrealistic, and the other involved the extensive use of "estimates" -- which is anathema to the IRS. As a result, much controversy existed in the 1950-1971 period.

In 1970, the President's Task Force on Business Taxation addressed itself among other issues to areas of controversy such as this one and strongly recommended new initiatives in regulations to reduce the resulting uncertainties in business taxation. 4/ The completed contract regulations were one of these initiatives. They followed perhaps the most intensive debate and analysis between the Treasury Department and the Internal Revenue Service of any of the regulation projects at that time. Among other objectives, they were deliberately designed to offer a reasonable alternative to the aerospace industry to resolve its unique tax accounting problems, while still protecting the interests of the Government by requiring capitalization and deferral of the deduction of costs until completion of the contract, thus denying the deduction "up-front" of substantial but perhaps unrealistic losses.

B. Development of the Regulations. The first proposed regulations contained a financial conformity requirement. This necessarily would have insured that costs could not be deducted for tax purposes before they were treated as cost-of-sales or expenses for financial accounting purposes. 5/ The conformity requirement would have dramatically restricted the availability of the completed contract method to all of the affected industries. It was severely protested by the construction industry and its Congressional representatives. It was thereupon abandoned.

4/ Report of President's Task Force on Business Taxation, Sept., 1970, p. 60.

5/ Prop. Reg. §1.451-3 (March 24, 1971).

The revised proposed regulations issued December 15, 1971, 6/ eliminated the financial conformity requirement but required complete consistency in the treatment of indirect costs with the full-absorption inventory regulations. Under the latter regulations, some indirect costs must be capitalized as inventory costs in all events, some must be deducted as period costs in all events, and some must be treated either as inventory costs or as period costs depending upon their treatment for financial accounting purposes.

In the final long-term contract regulations issued on January 14, 1976, this latter treatment of costs was eliminated. Instead, the Treasury Department undertook to specify the treatment of all costs either as costs of the contract, to be deferred until contract completion, or as period costs, in accordance with then-existing precedents in court cases and published rulings.

The final completed contract regulations provide that the current service portion of pension costs and certain other employee benefit costs need not be treated as costs of the contract, but rather are to be treated as period costs. 7/ This directly parallels the treatment of such costs with respect to self-constructed property. In I.T. 3408, 8/ a ruling still in

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6/ Prop. Reg. §1.451-3 (December 15, 1971).

7/ Reg §1.451-3(d)(5)(iii)(k). Compare Reg. §1.471-11(c)(2)(iii)(c) and (ii)(k).

8/ 1940-2 C.B. 178.

effect, the IRS determined that pension costs for construction workers are a period cost. When it proceeded to litigate the capitalization of depreciation with respect to self-constructed property in the Supreme Court in the Idaho Power Co. case, it specifically conceded the deductibility of pension costs, reflecting a widespread belief in the IRS that there is no authority to require any capitalization of qualified plan pension costs inasmuch as their deduction is provided for specifically in Code §404. 9/

The treatment of pension costs as a period cost in the long-term contract regulations is also consistent with their treatment in the full-absorption inventory regulations with respect to accrual basis taxpayers that employ a non-conforming method of accounting for financial reporting purposes. 10/

The relationship of the treatment of costs for inventory purposes under the accrual method and in the completed contract method is self-evident. Under the accrual method, income is accrued as deliveries of units occur and thus as the contractor is deemed to earn a specified portion of the contract

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9/ Commissioner v. Idaho Power Co., 418 U.S. 1 (1974). In 1978, the Internal Revenue Service commenced a regulations project, EE 56-78, to require capitalization of §404 costs with respect to self-constructed assets. The project has never been completed, possibly because of uncertainty as to the validity of the rule it would propose. See All-Steel Equipment Inc., 54 T.C. 1749, 1766 (1970); I.T. 3408, supra, footnote 8/.

10/ Reg. §1.471-11(c)(3)(ii)(k).

price for the units delivered. Costs of manufacturing the units, including allocable indirect manufacturing costs, must be capitalized as inventory costs and deducted as cost-of-sales as the units are delivered. Under the completed contract method, income is not accrued until the entire contract or program is completed, and costs of manufacturing the units (including certain allocable indirect manufacturing costs) must be capitalized and deferred until such completion. Losses may not be recorded under the completed contract method until the contract is completed; there are no exceptions to this rule. Under the accrual method, losses may be recorded by virtue of the cost-or-market inventory convention, to the extent of costs incurred, prior to the time that it is known whether or not losses will actually be sustained.

From the standpoint of tax policy, it is equally important to insure both that -- (1) losses are not recorded before they are actually sustained (except pursuant to the cost-or-market inventory convention); and (2) income is recorded at the time that it is actually earned. The accrual method as applied in the Space Controls and E.W. Bliss cases permits losses to be reflected based on estimates of future performance; the completed contract method, while not permitting the recording of losses, must be applied so as to insure that the contractor reports profits when there is sufficient certainty that they have been earned, but not before that time.

III. THE COMPLETED CONTRACT METHOD IS ESSENTIAL FOR PROPER TAX ACCOUNTING FOR THE AEROSPACE INDUSTRY

A. The Risks and Uncertainties of the Industry. The conceptual basis of the completed contract method was accurately stated by the IRS in 1970:

> One of the reasons why permission to report on a completed contract basis is given in the case of building, installation and construction contracts, is the fact that there are changes in the price of articles to be used, losses and increased costs due to strikes, weather, etc., penalties for delay and unexpected difficulties in laying foundations which make it impossible for any construction contractor, no matter how carefully he may estimate, to tell with any certainty whether he has derived a gain or sustained a loss until a particular contract is completed. 11/

These uncertainties, both as to price and to cost, exist to a much greater degree in the aerospace industry. Major technological break-throughs continue to occur during the development and production of any major weapons system, requiring extensive engineering changes to units already produced and yet to be produced, with resulting major uncertainties as to costs and prices for the product. These are technological changes not known at the time the contract was entered into. In fact, it is unique to the aerospace industry that it enters into combined development-production contracts of long duration calling for the contractor to invent and develop new products.

The result of these conditions is that in the performance of any major defense or commercial contract by the

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11/ Rev. Rul. 70-67, 1970-1 C.B. 117.

aerospace industry, there are very frequent technological advances, often overlapping and replacing one another, with major effects on cost. The uncertainties of costs and prices in the aerospace industry have very little, if any, counterpart elsewhere in American industry. Thus, there is no other industry in which catastrophic losses on particular contracts or programs occur in the magnitude and with the frequency and unpredictability that they occur in the aerospace industry.

On the pricing side, the Defense Department and other agencies buying from aerospace companies utilize the most sophisticated price techniques imaginable. They include infinite varieties of contracts which are fixed price, fixed price with redetermination clauses, fixed price incentive contracts, cost plus incentive fee contracts, cost plus fixed fee contracts, cost plus award fee contracts, and others. The incentive provisions may be based on the variation in actual costs from target costs, with maximum price provisions so that the contractor at some point bears the risk of 100% of cost overruns; or upon performance incentives based upon specific achievements, such as speed, altitude, rate-of-climb, accuracy of missiles, or more complex objectives; or upon value engineering concepts; or upon combinations of all of the foregoing factors. Major defense contracts in the aerospace industry, both cost and fixed price type contracts, normally contain provisions for cost and performance incentives which make profit highly uncertain until the completion of the contract, when the effect of the incentive provisions is first fully known. Operation of the incentive formulas could result in a final profit substantially greater or less than originally anticipated and negotiated, or could even result in a net loss. In addition, such contracts normally contain a ceiling price, exposing the contractor further to substantial risk of loss.

In addition to technological changes and incentive formulas, other regulatory and contractual provisions and procurement practices virtually assure that the profit or loss position of an aerospace contractor on a major defense contract cannot be ascertained with any reasonable degree of certainty until completion of the contract. The Government retains the right throughout contract performance to terminate the contract in whole or part for any reason. Such a termination can reduce very significantly the contractor's expected profit. Moreover, the Government frequently directs major changes to be made, but the contractor is required to proceed with the work as directed and to later negotiate the price for those changes. The difficulties in segregating the cost caused by such changes, quantifying the amount of increased or decreased cost resulting from the changes, and disagreements over allocation, allowability and reasonableness of cost incurred, can result in protracted negotiations and litigation with no assurance that the contractor will recover the full cost of such changes.

The Government is normally responsible for costs caused by defects in, or late delivery of, Government furnished equipment, drawings, and specifications. A contractor, however, can experience substantial delay, disruption, test, rework, and other costs before the problem might be identified as caused by the Government furnished equipment, drawings, and specifications and before the accounting procedures can be established to segregate such costs. A contractor's profit or loss position on a contract may vary significantly depending on the contractor's ability, on a retroactive basis, to identify and quantify such cost increases.

While the analysis in this statement tends to emphasize the uncertainties of prices and costs in defense contracting, these uncertainties exist to the same degree with respect to commercial business, including sales to domestic airlines and to foreign governments, foreign airlines, and others. These commercial sales are very substantial, and export sales are a large portion of total U.S. exports. The uncertainties are increased by intense competition both within and without the United States by foreign aerospace companies, often supported in varying degrees by their respective governments. The European airbus, for example, represents severe competition for U.S. aerospace products in sales to U.S. airlines.

The enormous risks of defense contracting are further reflected in particular programs that have been well-publicized. Grumman lost $260 million on the F-14 fighter program; Lockheed lost $484 million on a group of Government contracts, including the C-5A, Cheyenne helicopter, and SRAM missile motor, which were settled as a package in 1970; General Dynamics lost $359 million in building the SSN688-Class submarine. This list would be much longer if smaller companies were added. Arguments over efficiency, management, cost controls, technological problems, or otherwise are irrelevant in the present analysis; these numbers represent actual losses incurred that are deductible for federal tax purposes.

The cases are not limited to defense contracts. Lockheed announced in December, 1981, the discontinuance of the L-1011 program, with 1981 losses in excess of $800 million, following the previous recording of nearly $1.7 billion in losses on that program in the years 1968-1980. There have been other major commercial airplane programs in the last twenty years that have also resulted in major unexpected losses.

In the case of virtually all of these programs, the products were originally priced by both parties to yield a profit. The incredible technological developments in the aerospace industry in the last three decades have made it impossible to forecast costs, and thus prices, with the degree of accuracy required for effective tax administration. Contractors are frequently required to commit to prices before the product to be developed and manufactured has even been invented. The development and production of the end products is in a state of constant flux, both engineering-wise and cost-wise. The engineering changes on programs such as those above can range from 500 to over 6,000 or more during the course of a typical contract. There is no way to determine with reasonable certainty whether the manufacture and delivery of the products based on the initial cost estimates, and thus the contract price, will result in profits or losses.

The profit and loss uncertainties of the aerospace industry are further compounded by the Government procurement concept of "unallowable" costs. All Government contractors are required by P.L. 87-653 to make full disclosure of all anticipated costs in negotiating significant contracts and contract amendments. Pricing cannot, for the most part, reflect costs such as interest, advertising, or contributions, although these costs are very substantial in this industry, even with respect to Government business. In addition, other major costs are only allowable within strict limits, including, but not limited to, research and development costs, bid and proposal costs, and certain professional services. Studies have shown that these unallowable costs exceed 1.5% of sales, reducing before-tax earnings by 25 to 30%.

A 1974 report by the General Accounting Office 12/ reviews the "cost growth" in major weapons systems up until that time. The unanticipated cost-growth of 55 major weapons systems received was over $7 billion in six months' time. The report concludes as follows:

12/ Report to the Congress, Status of Selected Major Weapons Systems, Comptroller General of the United States (May 13, 1974).

> Cost growth in major weapon systems results from such things as unanticipated development difficulties, faulty planning, poor management, bad estimating, or underestimating. However, not all cost growth can reasonably be prevented. For instance, unusual periods of inflation may result in cost growth. Changes in technology may make it possible to incorporate modifications that result in an overall increase in the system's effectiveness. Such cost growth cannot always be anticipated, particularly when a weapon system is in development and production over long periods.

The statement that "not all cost growth can reasonably be prevented" is a significant understatement of the experience of the aerospace industry.

The unique risks of defense contracting are vividly illustrated by the magnitude of the cost and effort merely to compete for contracts. Agency requests to industry to submit proposals for programs such as SRAM missile, Cheyenne helicopter, C-5A, and B-1 aircraft average 1,000 to 2,000 pages, and contractors' responses normally range between 15,000 and 30,000 pages. 13/ One contractor expended $25 million in costs to compete for the F-15 contract, which it lost. In the case of the B-1 program, the Air Force spent $140 million on feasibility and other studies during 1965-70 to write the development specifications. Seven companies spent $66 million while preparing and waiting for receipt of the request for proposals and five companies spent $36 million in company funds

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13/ One program proposal to the Air Force for the AWACS contained 26,000 pages and involved 16,000 people in its preparation. Printed proposal material submitted by the three airframe and two engine contractors on the C-5A competition totalled 240,000 pages.

responding to the request. In short, it cost nearly one quarter billion dollars to prepare for the B-1 competition, to prepare the proposals, and to await the source selection decisions. 14/

The Department of Defense reported to Congress that major defense contractors incurred $3.3 billion in bid and proposal and independent research and development costs in fiscal year 1980. As a result of regulatory provisions limiting allocation of such costs to Government contracts, the Defense Department accepted only $2.6 billion of such costs for allocation to all of the contractors' work, commercial and Government. The share paid by the Department of Defense was $1.4 billion.

B. Cost-Type Contracts. Popular misconceptions exist that contractors in the defense industry are assured of recovery of their costs under cost-type contracts and that accrual of profit with reasonable certainty is possible. Nothing could be further from the actual facts.

Some cost-type contracts, whether cost plus fixed fee, cost plus award fee, or cost plus incentive fee, include maximum cost recovery provisions, exposing the contractor to substantial risk of loss of profits, or even some risk of loss. Some cost-type contracts give the Government an option to purchase additional quantities at fixed prices, or on a fixed price incentive contract basis, which subjects the contractor to major risk of loss of profit, or actual loss, when the

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14/ Report of the Commission on Government Procurement, December, 1972, Vol. 2, p. 137.

cost-type contract and the fixed price option are considered together. Further, in any cost type contract, the contractor is always at risk of loss of all or part of the fee because of "unallowable" costs, as previously described. The fixed fee on a CPFF contract will often be only in the 3% to 7% range, and unallowable costs can substantially reduce or possibly exhaust this narrow profit margin.

In the case of cost plus award fee contracts, the contractor's fee is entirely at the judgment of the Contracting Officer. This judgment ordinarily is not rendered until near the completion of the contract, when the most critical performance tests occur. The fee may range from 0% to 15% at the Contracting Officer's discretion. An interim award, say at 7.5%, can be eliminated by a final award of 0%. There is no way the fee can be accrued until the completion of the contract under traditional tax accounting principles --

> when all events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. 15/

In the case of cost plus incentive fee contracts, the same uncertainty exists until contract completion. Under a particular contract for a major acquisition of missiles, the "target" fee was to be 8% of estimated total "target" cost. The cost incentive provisions stated that cost overruns could reduce the fee to 5% and cost underruns could increase the fee to a

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15/ Reg. §1.451-1(a) (emphasis added).

maximum of 11% of cost. Performance incentives could further reduce or increase the fee by as much as 3% of costs. Thus, the fee could be as little as 2% or as much as 14%.

The performance incentives under the foregoing contract were heavily weighted toward flight tests and accuracy tests, which would occur in the last six months of a contract expected to require five years to perform. If the contractor were to accrue a fee of, say, 8% of costs incurred in the early stages of performance, a disastrous flight test and cost overruns could easily result in the necessity of booking a large negative fee in a very small amount of "sales" in the last year of performance. This is not the kind of certainty required for accrual of income for tax purposes.

Cost reimbursement contracts are used in those cases in which there is the most cost uncertainty. They are used where the work is essentially developmental in nature and thus where there is an inability to estimate costs to provide a basis for a fixed price type of contract . There is no comparable cost experience on any other contract, and no other reliable basis on which to determine costs.

In a very real sense, the completed contract method is most appropriate for cost-type contracts.

C. Other Existing Tax Accounting Methods Are Not Proper. The Treasury Department seeks to prescribe a new method of tax accounting, the progress payment method, for all long-term contracts, whether or not the taxpayer was previously using the completed contract method. Treasury would thereby discriminate against all businesses with long-term contracts, denying them the use of the traditional accrual method of accounting. This is done presumably to prevent such taxpayers from treating as cost-of-sales of initial units delivered the actual costs of those units, because this might result in substantial losses. Further, it prevents them from using the cost-or-market inventory convention to reflect losses at the earliest time those losses could be reasonably estimated.16/

This draconian solution of prescribing a new accounting concept made up out of whole cloth, with all the uncertainties it would bring, is wholly unnecessary. The completed contract method will work quite properly to require income to be reported when it is actually earned, and to deny the deduction of losses until they are actually sustained, with some changes in the regulations. There simply is no other tax accounting convention that is suitable to the unique problems of determining income or loss in the aerospace industry, as previously demonstrated. These same difficulties exist in the shipbuilding, heavy machinery, and construction industries.

The Treasury Department would permit use of the percentage-of-completion method, but their own explanation indicates that it is not suitable:

16/ See Space Controls, Inc. v. C.I.R., supra, and E.W. Bliss Company v. United States, supra, footnote 3/. But see Rockwell International Corp. v. Commissioner, supra, footnote 3/.

> However, it may be recognized that requiring this method in all cases may be difficult to administer and burdensome to taxpayers. 17/

This is a significant understatement. The percentage-of-completion method requires a determination of the degree of cost completion or physical completion of contracts. 18/ There is a substantial amount of subjective judgment applied in the use of the percentage-of-completion method. It is not possible in the aerospace industry (or probably any other industry) to make these determinations with sufficient accuracy for tax purposes, which requires annual tax accounting based on a reasonably high degree of certainty and objectivity.

It was this very impossibility, and the uncertainty of using estimates of future performance, that led to extensive reconsideration and the changes in the completed contract regulations in 1971. 19/ The IRS should not be satisfied with a tax accounting method which determines profits and losses in any given year by contractor estimates of future costs or future performance. Because of the inherent difficulties in the aerospace industry in determining costs and prices under contracts until they are completed, profits and losses cannot readily be

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17/ General and Technical Explanations of Tax Revisions and Improved Collection and Enforcement Proposals, Department of the Treasury, February 26, 1982, Completed Contract Method of Accounting, (hereinafter referred to as General and Technical Explanations), General Explanation, p. 4.

18/ See Reg. §1.451-3(c)(2).

19/ See, supra, pp. 7-13.

determined with respect to particular years; a transactional approach is essential. Thus, for example, the sophisticated pricing techniques for aerospace products may make it impossible to determine profits or losses on a year-by-year basis. The uncertainties in costs created by double-digit inflation and by the continuing galloping pace of technological change compound the difficulties. The uncertanity and controversy that existed prior to 1971 must not arise again. Lessons should be learned from the past. There is virtue in stability and certainty, particularly as to tax liabilities; indeed, it is a necessity. 20/

The Treasury's proposed "progress payment method" does not respond to these unique tax accounting difficulties. Indeed, it is so unsound in principle and in practical application that it would be disastrous to adopt it. 21/

IV. THE ADVERSE IMPACT OF DENIAL OF THE COMPLETED CONTRACT METHOD UPON OUR NATIONAL DEFENSE

Serious questions presently exist as to the capability of the United States defense industrial base to fulfill effectively its critical role in national security. In testimony before the Defense Industrial Base Panel, General Alton Slay, Commander of the Air Force Systems Command, observed that

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20/ Report of the President's Task Force on Business Taxation, September, 1970.

21/ See infra, pp. 30-37.

the United States had been able to generate a massive surge to mobilize its manpower and industrial base in the past, but that, today, the United States defense industrial base lacks standby capacity, weapons systems are more complex, "and we would be caught flat-footed for even the basic materials from which defense articles are made." 22/

The Administration is sponsoring increases in the procurement of defense products of the most sophisticated nature, placing further strains upon the capacities of our defense industrial base. The completed contract method contributes to severely-needed funds in the aerospace industry for both working capital and new capital investment. This is essential to a rejuvenated defense program. The Accelerated Cost Recovery System can provide only limited benefits, because many companies in the industry are more labor-intensive than fixed asset-intensive, as contrasted with other major United States industries.

It is sometimes overlooked that defense contractors typically have large net investments in work in process under Government contracts as well as under commercial contracts. While the cost of operating capital necessary to finance work in process has increased dramatically, the cost of money for operating capital is not an allowable cost under defense contracts. The usual progress payment has been 80 percent of costs

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22/ Federal Contracts Report, Bureau of National Affairs, Vol. 857, Nov. 17, 1980, p. A-25.

for contractors other than small business (increased to 90 percent in late 1981). Because of time lags in recording costs, submitting billings, and receiving payment, a recent industry survey indicated that progress payments provide only about 60 percent of the working capital investment and the contractor must provide the balance of 40 percent (which should drop to about 30 percent with 90 percent progress payments). 23/

As previously demonstrated, a major purpose of the revision of the long-term contract regulations in the period 1971-1976 was to attract the aerospace industry into that tax accounting system to provide reasonable certainty of tax consequences and forestall acceleration of estimated losses. The Treasury's program was successful, with virtually all major aerospace contractors now having adopted the method. A recent, informal survey of twenty-two major aerospace defense contractors was conducted. About one-half of these companies reported that the deferred tax liability attributable to the completed contract method is now equivalent in amount to 25 percent of the shareholder equity of these companies.

As noted previously, withdrawal or substantial curtailment of the right to use the completed contract method will cause tremendous uncertainty in the aerospace industry. Years of litigation may ensue, which will affect significantly the

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23/ Federal Contracts Report, Bureau of National Affairs, No. 864, January 12, 1981, p. D-7.

financial positions of companies and force them to make important operating decisions without any degree of certainty as to the outcome.

Under these conditions, any such withdrawal or substantial curtailment could have very serious adverse effects on United States defense capabilities and on this industry. It would require the industry to go to the financial markets for massive amounts of new capital. The industry is already poorly-rated by the financial markets, and new capital would be obtained, if at all, only at unduly-high interest rates. Weaker companies, though owning facilities which are vital to our national defense industrial base capacity, could be forced into unwise mergers. In extreme cases, for national security reasons, Government intervention might be necessary.

Although interest for the most part is not an allowable cost for defense pricing purposes, it obviously must be recovered by aerospace companies in the pricing of their products. Accordingly, profit percentages on defense contracts necessarily reflect the interest and other debt service costs of the contractor. The Government has recovered much of the benefit of the completed contract method through lower prices, resulting from reduced profit rates made possible by the deferral in time of payment of contractors' tax liabilities. If the industry must incur market interest costs on borrowings to replace this capital, the Government will bear much of the cost in higher profit rates on new defense contracts; otherwise, the defense industrial base will be eroded. To the extent the cost of borrowing in the marketplace exceeds the implicit interest rate borne by the United States on its debt, or earned on its funds, the Government will incur added defense costs unnecessarily.

More importantly, in any transition process, the United States will lose much of the dynamic progress presently underway in the aerospace industry in improving its productive capacity, its efficiency, its investment in new independent research and development, and its capital planning. This progress has been ignited by the President's determined program to increase defense expenditures so as to improve our strategic position, our defense capacity, our defense industrial base, and our research in new weapons systems and aerospace science. The Department of Defense has been promoting these developments by new initiatives such as flexible progress payments, economic price adjustment clauses, and multi-year procurement commitments.

In summary, if a major change in use of the completed contract method is to have any substantial revenue effect, the defense posture of the United States would be jeopardized in many ways. The Government would lose more than it would gain.

V. THE TREASURY DEPARTMENT'S PROGRESS PAYMENT METHOD WOULD BE COMPLETELY UNWORKABLE AND INEQUITABLE

The Treasury Department proposes to require that the "progress payment" method or the percentage of completion method be used for all "long-term contracts". 24/ As previously indicated, the Treasury recognizes that virtually no one would use the percentage of completion method. 25/ Thus, all businesses manufacturing special order products normally requiring more than one year to complete, and all of the construction industry, would be forced to use this new "progress payment" method whether or not they have been using the completed contract method. For example, a small businessman producing special order products requiring more than one year to manufacture who uses the traditional accrual method of accounting, capitalizing his direct and indirect production costs as inventory, will be forced to use this new method even though he has had absolutely no problem with the IRS as to his tax accounting method. The results of this change would be absolutely chaotic.

The Treasury's new "progress payment" method would cause severe tax accounting difficulties. These difficulties are so great that Treasury itself, although it announced the new method only twenty-one days ago, 26/ is already discussing substantial changes in its written proposal.

The proposed new method has major conceptual and practical flaws. It sounds like a cost-recovery method, a

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24/ A "long-term contract" is a building, installation, construction, or manufacturing contract which is not completed within the taxable year in which it is entered into for unique items not normally carried in inventory and which normally require more than twelve calendar months to complete. Reg. §1.451-3(b)(1).

25/ See supra, pp. 24-25, and footnote 17.

26/ See footnote 17, supra.

thoroughly unsatisfactory concept for tax accounting and one which this Committee only recently disfavored. 27/ It requires that borrowings in lieu of payment be treated as income. 28/ This may raise Constitutional risks; receipt of the proceeds of a loan is not "income" within the scope of the Sixteenth Amendment. 29/ Furthermore, it is utterly impractical to determine whether borrowings are "in lieu of payment". If the purchaser lends the seller funds and takes a lien on his general assets, rather than having such loans "secured by the contract", presumably the amount is not treated as income. This will lead to artificial, contrived, arrangements and cause differing treatment of similarly-situated taxpayers.

Treasury itself recognizes that this "borrowing" rule presents difficulties and has proposed that the amount be taken into income ratably over a twelve-month period. 30/ It appears Treasury is already considering variations of this rule, but the rule itself is wrong in principle, and all of the difficulties it will create cannot be foreseen.

An even more fundamental objection to the "progress payment" method is that it would not allow losses on the contract

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27/ Sen Rep. 96-1000, 96th Cong., 2d Sess. 24 (1980) (H.R. 6883, Installment Sales Revision Act of 1980).

28/ General and Technical Explanations, pp. 4, 9.

29/ Consolidated-Hammer Dry Plate & Flim Company v. CIR, 317 F. 2d 829 (7th Cir. 1963); United States v. Ivey, 414 F. 2d 199 (5th Cir. 1969).

30/ General and Technical Explanation, p. 9.

to offset profits on another. 31/ Similarly, Treasury has advised that if under the method, profits are reported on a particular contract, but later losses are incurred on that contract, the losses cannot be used to offset the profits reported earlier and cannot be deducted until some future year when net cash flow arises or upon completion of the contract. These rules will result in taxpayers being required to report phantom profits that never exist, and they further compound the Constitutional infirmities of the new method. There is virtually no precedent in our income tax system for denying a taxpayer the right to offset losses within a single business against profits on other transactions within that business. The elaborate carryback and carryforward provisions of the Internal Revenue Code are adequate evidence of a policy to permit profits and losses to be offset so that only true income is taxed.

The Treasury proposals call for a new concept of allocating virtually all indirect costs to long-term contracts even though they do not directly benefit the performance of those contracts. 32/ This would reverse seventy years of tax accounting history in our income tax system and create extraordinary uncertainties and inequities.

The existing long-term contract regulations already require that both direct and indirect costs attributable to particular long-term contracts be allocated to those contracts;

31/ General and Technical Explanation, p. 10.

32/ General and Technical Explanation, pp. 7, 9.

the result of this treatment is that deduction of the costs is deferred under the completed contract method until contract completion, when either the profit or loss from the contract is determined. The regulations permit the current deduction as period costs of expenses that benefit the taxpayer's "activities as a whole", such as the salary of the president of the corporation. This regime is, with some exceptions, consistent with the tax treatment of business taxpayers in general under the inventory regulations, where precisely the same types of cost allocation rules are required. These inventory regulations, in turn, are based on traditional financial accounting and tax accounting concepts, and they represent the product of a long history of experience and adaptation to developing principles of financial accounting and cost accounting.

The Treasury's proposed new requirement for comprehensive allocation of virtually all indirect costs, even those not directly benefitting performance of long-term contracts, has no basis in financial accounting, cost accounting, or tax accounting, and will be completely unworkable. How, for example, is interest on general corporate borrowings, such as a long-term bond issue to build new facilities, to be allocated to particular long-term contracts? The Defense Department does not permit interest to be allocated as a cost under defense contracts. The virtual impossibility of allocating interest expense effectively under §265(2) of the Internal Revenue Code is well-known to all tax professionals.

Treasury would require allocation, and thus denial of a current deduction, for some research and experimental expenses. 33/ This flies in the face of a deliberate Congressional policy in Code §174 to encourage research and development by allowing a current deduction for all such costs. Treasury would require allocation, and thus denial of a current deduction, for all Accelerated Cost Recovery System (ACRS) depreciation amounts, to the extent allocable to long-term contracts. Treasury would thereby discriminate against taxpayers with long-term contracts by denying them the immediate benefits of the tax incentives just adopted by Congress in the Economic Recovery Tax Act of 1981 for new capital investment in plant and equipment.

These rules make no sense whatsoever.

Treasury provides no guidance for the allocation of indirect costs not related to the performance of particular long-term contracts. There are no precedents for allocation of these costs for tax purposes. The Treasury's proposed rules for such comprehensive cost allocations are far more extensive than the rules generally applicable to accrual basis taxpayers maintaining inventories. Yet, there is no reason in principle why a taxpayer manufacturing special order goods (requiring more than twelve months to produce) should be forced to capitalize and defer the deduction of costs that other manufacturers may deduct currently. These costs are period costs; they are not

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33/ General and Technical Explanation, pp. 7, 9.

costs of manufacturing the product sold by the business. They are costs which occur regardless of the amount of product manufactured.

The result of the Treasury's proposal would be that a tremendous pressure would arise for a long-term contractor to restructure his business operations so that his contracts ceased to be "long-term contracts". By avoiding such classification, he could utilize the more reasonable cost allocation rules applicable to accrual basis taxpayers in general.

This pressure will cause great complexity, uncertainty, and litigation. In the past, taxpayers have often sought to have their business operations classified as "long-term contracts" so that they could obtain the certainty of tax treatment offered by the completed contract method. There has been no incentive deliberately to avoid such classification, since the taxpayer was always free to use the traditional accrual method for tax purposes if he chose. Now, however, there will be a strong, new incentive to avoid classification of activities as "long-term contracts". This is a very difficult determination to make, as should be evident from a study of the definition of a "long-term contract" in the existing regulations. 34/ The Treasury's proposed new regime will cause chaos in business tax reporting for a wide range of businesses.

There is no need for all the uncertainty, inequity, and complexity that this major change in tax accounting would

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34/ See footnote 24, supra.

bring. The completed contract method can be refined by changes in the regulations which will eliminate the problems which have arisen in its operation. The Aerospace Industries Association has suggested a number of possible changes to the Treasury Department and has offered to participate in an intensive dialogue to help resolve other concerns of Treasury. The changes, however, must be entirely consistent with the provisions governing business taxpayers in general under the inventory regulations. Any other approach will result in intolerable inequities and complexities.

VI. REVENUE IMPACT

The revenue consequences of withdrawal or substantial curtailment of use of the completed contract method by the aerospace industry would be quite uncertain. A reasonable transition rule would be an absolute necessity. The Treasury Department proposes a so-called cut-off method whereby long-term contracts entered into before February 26, 1982, could continue to be reported on the completed contract method, using the old cost allocation rules, by a taxpayer presently using that method; long-term contracts entered into between February 26, 1982, and December 31, 1982, by such a taxpayer would be reported until December 31, 1982, on the completed contract method using the old cost allocation rules and thereafter on the progress payments method; and long-term contracts entered into after December 31, 1982, would in the case of all taxpayers be reported on the progress payment method.

If the Treasury's proposals were to be adopted, this seems unduly complex. At the very least, long-term contracts entered into before December 31, 1982, should continue to be reported on the completed contract method, using the old cost allocation rules, by a taxpayer using that method.

More importantly, the Treasury proposal provides far less transitional relief than it suggests because it makes costs deducted under the old cost allocation rules in years after 1982 a "tax preference" for purposes of the Treasury's proposed new corporate minimum tax. 35/ This effectively cancels out about one-third of the benefit of the transition rule. There is no reasonable basis for this treatment.

The Treasury's proposal applying the proposed new corporate minimum tax to long-term contracts entered into in prior years is particularly harsh and unjustified, and it would impose a severe, added financial burden on the aerospace industry. The minimum tax would be imposed even though the contract ultimately results in a loss. This is perverse. All of the other listed tax preferences always result in a tax benefit to the taxpayer. Here, however, the minimum tax may be imposed even though the completed contract method has served to defer a loss deduction -- resulting in a tax preference to the Government.

35/ General and Technical Explanation, p. 12; see also General and Technical Explanation, Corporate Minimum Tax, pp. 42, 50-51.

To the extent that Congress were to provide more reasonable transition rules, and to the extent Congress were to require less-draconian cost allocation rules, the revenue from this poorly-conceived Treasury proposal to require the progress payment method for all long-term contracts would be less. The revenue gain in the 1983, 1984, 1985 period would become far less significant, so that the change would have little impact on the projected three-digit deficits in the next several years.

In the case of new contracts resulting from increased defense expenditures, or otherwise, the impact will be delayed substantially. Contracts in the aerospace industry, whether defense or commercial, typically involve long lead-times from the time of execution until the time when substantial production activity is undertaken and deliveries are made.

Thus, it may be unlikely that withdrawal or substantial curtailment of use of the completed contract method by the aerospace industry will begin to have any substantial revenue consequences until 1985 or 1986. This does not mitigate the adverse impacts of any such action upon defense policy, 36/ however, since the capital planning of the industry would be disrupted by the action itself, even though its revenue impacts were delayed several years in time.

36/ See supra, pp. 26-30.

VII. CONCLUSION

The use of the completed contract method is vital to proper tax accounting in, and to the financial stability of, the aerospace industry. There is no reasonable alternative that might not allow either undue acceleration of losses that may not be actually incurred, on the one hand, or the reporting of taxable income that may never materialize, on the other hand. The risks and uncertainties of the aerospace industry are extraordinary and unique, and unanticipated "cost-growth" in major weapons systems is the rule rather than the exception. The pricing and costing of products of the aerospace industry necessarily reflect major technological uncertainties and are only fairly reflected for tax purposes by the completed contract method.

The Treasury Department carefully developed the completed contract method in regulations in the 1971-1976 period for, among other purposes, the objective of resolving the tax accounting treatment of the aerospace industry. This thorough consideration and evaluation should not be abandoned.

The aerospace industry responded by accepting the Treasury's invitation to use the completed contract method almost on a universal basis. The result is that a large part of the operating capital of the industry is now reflected in deferred tax liabilities attributable to the completed contract method. A withdrawal or substantial curtailment of the method could have severe adverse impacts on the aerospace industry and thus on the United States defense industrial base. The

ACRS system is by no means a substitute. The important initiative in capital planning, increased efficiency, independent research and development and increased capacity which have been stimulated in the aerospace industry by the present Administration should not be disrupted by such a tax change.

The Treasury Department's proposed alternative tax accounting method, the "progress payments" method, would have disastrous effects. The method seeks to treat as income borrowed funds. It specifically denies taxpayers the right to combine profits on some contracts and losses on other contracts, or even profits and losses on the same contract in different years, to determine their real income. It denies current deduction of certain research and development costs and the new Accelerated Cost Recovery System deductions. It requires cost allocations to long-term contracts that cannot reasonably or fairly be made. It denies businesses with long-term contracts the existing, reasonable cost allocation rules for all other businesses.

These circumstances will create strong incentives for business to rearrange their business transactions so that they are not "long-term contracts" simply to avoid the unreasonable new cost allocation rules. The net result of the Treasury's new method will be to create massive confusion, uncertainties, complexities, administrative difficulties for the IRS, and inequities inasmuch as similarly-situated business taxpayers will be treated differently. It should be sharply rejected.

The revenue effect of the Treasury's proposals will be highly uncertain in the near term (1983-1985). This results from the necessity of appropriate transition rules and the delayed effect of any such change. Major tax accounting controversies will result from the abandonment or substantial modification of the completed contract method and forced adoption of the progress payment method. The consequences may be as destructive for the Treasury Department as for the aerospace industry. To make such changes and label them as a "loophole closer", in view of the Treasury's original intent in thfs area to raise revenue, is to distort the history of the development of the completed contract method.

This Committee should immediately advise the Treasury Department not to issue any proposed regulations until the issues involved have been considered by the Committee. The Committee ultimately should resolve this matter by advising the Treasury Department to revise the long-term contract regulations to preserve the completed contract method but to eliminate any undue benefits in its application as demonstrated by experience over the last ten years. The cost allocation rules should be revised to achieve greater consistency with the regulations governing all other business taxpayers -- that is, accrual basis taxpayers maintaining inventories. There will be significant revenue gains to the Federal Government from such changes. The Aerospace Industries Association has already made many constructive suggestions to the Treasury Department to achieve these objectives and stands ready to engage in a continuing dialogue with Treasury to achieve greater equity, simplicity, and consistency in the tax treatment of long-term contracts.

AEROSPACE INDUSTRIES ASSOCIATION

John S. Nolan

John S. Nolan
Counsel

March 19, 1982

Senator CHAFEE. You have sent your suggestions to the Treasury on how this could be reformed, on some improvements which could be made, or on corrections of abuses. Is that right?

Mr. NOLAN. Yes, Senator. We have submitted a 40-page analysis of the problem to the Treasury a month or so ago, and many of our suggestions are reflected in their proposals that they have made. But their proposals are much more extensive and are not consistent. They are not well thought through. They need a lot more thought and attention.

The CHAIRMAN. You mean theirs or yours?

Mr. NOLAN. Theirs.

QUESTIONS SUBMITTED BY SENATOR DANFORTH TO JOHN S. NOLAN AND HIS ANSWERS THERETO

Question 1. The Secretary of the Treasury recently testified that the completed contract method of accounting has resulted in "unintended tax benefits" to those using it. How would you respond to this statement?

Answer. The completed contract method does not and has not resulted in "unintended tax benefits". The method dates back to 1918. It was thoroughly examined by the Treasury Department, the Internal Revenue Service, and the staff of the Joint Committee on Taxation from 1970–1976 before the 1976 regulations were amended in 1976 when the method was extended to manufacturers. The period costing rules applicable to long-term contracts were a part of this study and were extensively revised and updated by the 1976 regulations. A deliberate decision was made at that time that the completed-contract was the best method of tax accounting for these contracts.

I do not suggest, however, that the 1976 regulations cannot or should not be revised to make further improvements. Certainly after seven years of additional experience with the method, the regulations can be improved still further. The Aerospace Industries Association has suggested a number of specific improvements. This is a matter which should be dealt with administratively by the Treasury.

Question 2. What is the function of progress payments in your industry, and how do they relate to the ultimate gain or loss a contractor recognizes on a contract?

Answer. In the aerospace industry, progress payments serve as a financing device to provide working capital to the contractor for performance of the contract. This enables the customer to pay a lower price, since the contractor, to that extent, is not required to include interest on working capital as a cost or an element of profit in the price. Progress payments are generally some percentage, such as 80 percent or 90 percent, of costs incurred. Progress payments ordinarily do not include any "profit" element. Profit arises, or loss is incurred, when the contractor completes the contract and the price to be received can be compared with the costs that have been incurred. In the aerospace industry, the final price and the costs incurred generally cannot be determined, even with respect to interim deliveries of work under the contract, until the contract has been completed. This occurs because the final price is usually geared to performance, cost, and/or value engineering incentive provisions, and because costs are constantly changing as technological changes are made in the contract terms during contract performance.

It is also worth noting in the aerospace industry that the government often disallows many costs incurred in the performance of contracts. It therefore is possible for a company to sustain a loss even on a cost-plus-fixed-fee contract. In any event, the normal pattern in the industry is for payments to lag behind incurred costs, and for some cost reimbursements to be disallowed, with the result that the companies are typically "behind" in terms of cash flow when performing contracts.

The flow of progress payments on a contract in relation to costs incurred thus has no relationship to the ultimate profit or loss on a contract.

Question 3. In your opinion, if the completed contract method is eliminated, how will this affect the companies in the organization you represent?

Answer. Most of the companies in the aerospace industry use the completed contract method. The method avoids disputes with the Internal Revenue Service because the companies are not required to estimate profits and are prevented from deducting losses during the period that the contracts are being performed. As I noted earlier, in the typical case, aerospace companies are "behind" on their contracts on a cash-flow basis. The completed contract method has the virtue of assuring that revenues and costs from a particular contract are properly matched, and that profits are not reported until actually earned and losses are not deducted until actually sustained. No other method of accounting for long-term contracts has these advantages. All other methods involve the use of estimates, often subjective judgments, to determine what profits or losses to report for each particular taxable year.

The first effect of eliminating the completed contract method will be a return to the situation before the 1976 regulations were aerospace companies and the Internal Revenue Service were in continuous dispute as to what estimates of expected revenue and expected costs should be used. The resulting uncertainty in the aerospace industry as to its tax liabilities would be extremely destructive of efficient operation and sound capital planning.

The second problem from elimination of the completed contract method would be the extremely severe financial problem it would create for aerospace companies. At this time, many companies employing the completed contract method have substantial deferred taxes which are very large in amount in relation to their net worth. The industry is cash poor. A radical change in the accounting treatment of the industry's contracts without adequate transition rules would, therefore, be catastrophic. Most companies would be required to finance the taxes in the marketplace at high interest rates. Many companies do not have the credit standing to finance at acceptable rates and they could be forced into unwise mergers or other corporate reorganizations.

If Congress were to provide adequate transition rules so as to cushion the financial blow to these companies, most of the short-term revenue gain sought by the Treasury Department would be eliminated. The long-term adverse effects on the industry would remain, however. The companies would still be forced to adjust to the fact that the deferred tax financing would be eliminated. As I mentioned earlier, these companies are cash poor and will face increased financing costs. The industry will have to recoup the increased financial burdens in the pricing of its products, prices to be paid in large part by the Defense Department. The interest cost to the industry of outside financing would exceed the implicit interest cost of the deferred tax liabilities under the completed contract method. In the long run, the impact of the Administration's proposals on the industry insofar as government contracts are concerned, will be no additional net gains to the government and perhaps even net losses. In the short run, with the transition rules customarily permitted for accounting method changes, there will be no substantial gain in revenue to the Treasury. In any event, the industry will be greatly burdened and handicapped as it makes the substantial adjustments required to live with the Administration's proposals, and its capital planning for the necessary increases in our defense capacity over the next ten years will be severely disrupted.

Question 4. Do you believe that the deferral period of contractors is increasing because of inflation and the increasing size of contracts?

Answer. Your question assumes that the contracts in question will turn out to be profit contracts. Many contracts, particularly in an inflationary environment, turn out to be loss contracts, even though initially the expectation is that they will result in profits. But on your premise, it is correct that greater deferral generally arises under the completed contract method as opposed to other accounting methods in periods of increased inflation and periods of increased business. By the same token, when defense spending is reduced, as it is periodically, at least on a company by company basis, so that a particular company's business levels off or declines, the completed contract method will produce greater income for that company and thus greater tax revenues in the years of contract completion as opposed to other methods. The tax liabilities are merely deferred, not reduced.

I answer your question generally because in practice some other tax accounting methods can result in greater deferral under your assumptions. For example, the percentage-of-completion method has been known to generate losses while a contract is performed, even though events occur in a later year to cause it to be a profit contract. Under the completed contract method, losses can never be deducted before contract completion. Under the accrual method, it is possible to recognize losses on a profit contract in a year well before the contract completes. As I indicated earlier, this problem was one of the major reasons why the regulations were changed in 1976 to provide for use by manufacturers of the completed contract method for their long-term contracts, where uncertainties and controversies with the IRS over such losses and as to profit estimates during contract performance, before contract completion, had caused so much difficulty in the aerospace industry.

Question 5. Do you believe the DOD is in favor of retaining the completed contract method?

Answer. We are not aware of DOD's official position regarding the completed contract method. We would expect DOD to be deeply concerned, if not alarmed, over the Treasury's proposed changes. There is no question but that the prices for DOD procurement will increase as a result of the Treasury's proposal. Equally important, it must be a source of great concern to DOD that the change would require massive capital infusions from private sources to pay the increased taxes and that this would be so disruptive to the aerospace industry in its critcal capital planning. The change clearly would undermine the aerospace industry's ability to serve national defense needs.

Question 6. What is your reaction to the Administration's proposal to have certain costs, such as R&D and interest, allocated to contracts rather than deducting the costs currently?

Answer. As we now understand the Treasury's proposal on R&D, they are not proposing to allocate to any long-term contracts any R&D which is company-sponsored or for which the company is assuming the risk that it will not recover its cost. This would include R&D for a new commercial airplane which the company expects to sell to airline companies and recover its R&D costs in the price of the airplanes. We understand also that the Treasury's proposal on R&D does not apply to so-called independent research and development expenditures which, within limits are included in a company's overhead which may be allocated in part to DOD contracts. The Treasury's proposal is limited to the case where the R&D is contracted-for R&D. While the Treasury's position is not entirely consistent with the policy of Congress embodied in Code § 174 allowing R&D to be expensed and in Code § 44F allowing a credit for certain increased R&D, it is not unreasonable.

We strongly oppose, however, the Treasury's proposal requiring interest to be capitalized and treated as a contract cost. There is an enormous administrative problem with this proposal. The DOD does not treat interest expense as a reimbursable contract cost for contract pricing purposes; the company must look to its profit margin to recover this cost. The companies do not allocate interest to their contracts for financial purposes and have no reason to do so. There are no workable bases for allocating interest costs to contracts.

Interest is a fungible cost; the benefit of financing affects the business operation as a whole in many different ways. Funds generated through the pledge of inventory assets may, for example, be used to build a new plant. Funds generated from a mortgage on land might be used to fund the working capital needs of the business. Government contracts are not and cannot be used as security for debt.

The proposal therefore would require the use of some arbitrary tracing concepts so that interest might be allocated to particular contracts. The Internal Revenue Service has had impossible enforcement problems in attempting to apply tracing concepts with respect to the cost of interest incurred on debt to finance the acquisition of tax-exempt obligations. In the case of banks, the IRS has in effect given up and acknowledged that tracing even by arbitrary means is impossible. The same problems would be created in the aerospace industry by this new proposal by Treasury.

Aside from the administrative problem, the proposal runs counter to the treatment of interest generally in the business world. Interest is universally regarded as a period cost, that is, an expense of the period of time for which it is incurred, not a cost of the product. Interest incurred to carry inventories for example is a period cost, not an inventory cost. There is one exception in the case of real estate construction period interest, where in some instances interest is capitalized and is amortized over generally a ten-year period. Here, the interest can be clearly identified with a specific project—a situation not present in the case of long-term contracts involving, in the typical business operation, many different contracts for various items and of various contract lengths.

Question 7. Based on your knowledge of the aerospace industry, do you feel the Treasury revenue estimates related to this proposal are accurate?

Answer. The Treasury proposals will not result in the revenue gains Treasury projects for the next two or three years. We understand that the Treasury estimates are based upon a strict transition rule. If the Congress follows traditional concepts, in providing liberal transition rules, the revenue gains from accelerating the deferred tax liability will be spread over many taxable years. We also feel that several elements of the Treasury's proposals are quite onerous and that Congress will not accept much of what Treasury has proposed. Treasury itself is already considering changes in its proposals. The Treasury proposals treat taxpayers with long-term contracts much more harshly than taxpayers with inventories. This treatment cannot be justified, and if the Treasury proposals are modified to be consistent with the treatment of taxpayers without long-term contracts, the revenue gains from the Treasury proposals will be substantially reduced.

Question 8. Mr. Nolan, let's assume that the Congress adopts the Administration's proposal, thus barring future use of the completed contract method, and decreeing that two, and only two, accounting methods shall be used, namely, a percentage of completion method and the progress payments method. Am I correct that the first of these methods has been used in the past without great success and that the other method is an entirely new concept? And, if I am correct in those two assumptions, do we run the risk of starting a long and costly process of litigation and regulation writing?

Answer. You are correct, Senator, on both questions. The percentage-of-completion method requires the use of a great deal of subjective judgment and estimates, and it is not satisfactory for tax purposes. No matter what estimates are employed, reasonable men will differ, and it is inevitable that many disputes will arise with the Internal Revenue Service over application of the method, as the past has demonstrated. Taxpayers can be expected under the percentage-of-completion method to use low estimates on the income side and high estimates on the expense side. The Treasury's own proposal recognizes that many taxpayers will find this method unattractive from the standpoint of uncertainty and difficulty in its application.

The Treasury's progress-payment method is a new concept to the tax law, untried and untested. Essentially, it would tax cash flow, which has little to do with whether the taxpayer is making or losing money. The method would tax advance payments as income even though those advance payments are intended and designed to provide financing to the taxpayer. There is a constitutional issue here whether a taxpayer can be taxed on receipts which are not income.

Another unfair aspect of the progress payment method is that it would require recognition of income but deny the recognition of losses while the contract is being performed. The method would require taxpayers with long-term contracts to defer the deduction of many more costs than the treatment applicable to taxpayers without such contracts. It does not take much analysis to recognize that significant disputes will arise in this new system of taxing long-term contracts over what is a "long-term contract". Taxpayers will have an incentive to structure their affairs so as not to have long-term contracts. Disputes will arise over whether payments or concessions made in advance of contract work are taxable payments or are non-taxable loans under the method. There are inherent administrative problems with any method which seek to tax cash flow as opposed to net income. There are inherent administrative problems with any method which restricts the allowability of losses but taxes profits as a contract is performed.

Question 9. If there are problems in the present application of the completed contracts method of tax accounting, are they problems of concept and method, or are they problems of technical interpretation?

Answer. As my earlier answers indicate, there are no problems as to theory or concept with the completed contract method. The method is also easy to apply from the administrative standpoint and ensures that revenues are matched with income for each contract. Both losses and profits are deferred and are not recognized prematurely.

I have already noted that the Treasury's progress payments method has fundamental conceptual objections—it taxes receipts which are borrowings, not income; it does not recognize losses as they are incurred; and it prevents losses on some contracts from being offset against profits on other contracts.

As we see it, there are some administrative or technical problems with the completed contract method which appropriately should be dealt with by revising the regulations. For example, greater guidance might be provided to taxpayers and to revenue agents as to when contracts complete and as to whether particular contracts should be severed or aggregated. We also feel that the Internal Revenue Service could provide better guidance to its agents than it had on these points through the issuance of revenue rulings, etc. The Aerospace Industries Association has suggested a number of specific improvements in the regulations that would make the completed contract method work more effectively.

Question 10. Mr. Nolan, if there are problems in the existing application of the completed contract method of accounting, how do you think they are best resolved?

Answer. As I indicated earlier, this is a matter which should be dealt with through changes in the regulations. It is not matter requiring Congressional change. It clearly is not a matter requiring an established, acceptable method of tax accounting to be discarded and the adoption of a new, untried accounting method. I should note the Treasury has even proposed that the accrual method of accounting be eliminated with respect to longterm contracts, which in many respects is an even more radical proposal than the proposal to repeal the completed contract method.

It is apparent to us that there are many misunderstanding in the Administration as to the present accounting treatment of long-term contracts. There seems to be the impression that taxpayers frequently have contracts running for as long as twenty years and there seems to be the impression that nearly every taxpayers is engaging in intentional abuse. In our industry, nearly all contract are completed within six years. Most companies have endeavored to adopt a reasonable interpretation of the regulations where the regulations fail to deal with the specific point in question. Here, work needs to be done to revise and improve upon the existing regulations.

We feel that if changes are to be made in this area, the changes must be examined in the context of inventory tax accounting in general and in the context of the tax accounting treatment of advance payments in general. The entire subject will not stay resolved if a new, harsh treatment is applied to long-term contracts, with other, more reasonable rules continue to apply to business that is done other than pursuant to long-term contracts. Too much pressure will be created upon taxpayers to restructure their business operations to avoid the harsh treatment applicable to long-term contracts. Thus, the change in treatment of long-term contracts must be considered in the context of the treatment of other business taxpayers with inventories.

At this point, I doubt that Congress is sufficiently informed and equipped to balance all of the interest involved. This is a highly technical matter, a matter clearly inappropriate for the regulations writers. We therefore feel that the Congress should direct the Treasury Department to deal with these problems administratively in the context of balancing and maintaining consistency with the inventory accounting rules. The aerospace industry has been and is willing to work with the Treasury on this matter. This was the very purpose of the aerospace industries submission to the Treasury in January of this year, an offer made even before the Administration's legislation proposals were made to the Congress.

STATEMENT OF WILLIAM C. DANIELS, VICE PRESIDENT AND TREASURER, J. A. JONES CONSTRUCTION CO., CHARLOTTE, N.C., ON BEHALF OF THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA, WASHINGTON, D.C.

Senator CHAFEE. Mr. Daniels.

Mr. DANIELS. Mr. Chairman and members of the committee, my name is William C. Daniels, Jr. I'm vice president and treasurer of J. A. Jones Construction Co. in Charlotte, N.C.

Today, I am testifying for the Associated General Contractors of America as chairman of its Tax and Fiscal Affairs Committee.

I would like to present briefly a statement today and have the full text entered into the record along with a technical analysis which has already been given to the Treasury Department.

The Associated General Contractors of America, AGC, represents more than 30,000 firms, including 8,400 of America's leading general contracting companies, which are responsible for the employment of more than 3½ million people. These member contractors perform more than 80 percent of America's contract construction of commerical buildings, highways, industrial, and municipal utility facilities. I am testifying today on a tax revision included in the administration's 1983 proposed budget. The revision deals with the completed contract method of accounting for income tax reporting.

Senator CHAFEE. Mr. Daniels, we will just not have time for you to go through this whole statement. You proceed as you wish, but we will have to cut you off at the end of your allotted time. Why don't you summarize? Take the points you particularly want to stress.

Mr. DANIELS. The proposal as it is presented to us would begin to tax in the first taxable year. There is some suggestion that changes may be offered, but as it was presented to us, it would begin to tax in the first taxable year revenue in excess of costs on projects which are in a positive cash-flow position. It would not permit projects which are in a cash-deficit position to be consolidated against those. In other words, we would be paying tax on revenue which is not related to profit. We would not be permitted to take the cost on the contracts which are in a deficit position, and which eventually may result in a loss, and consolidate that against the positive cash-flow contracts.

There is no way profit on any project can be known until it is completed. We think it is totally inappropriate to attempt to tax on revenue rather than on profits. Contractors routinely in their negotiating and bidding processes try to get revenues in greater proportion in the early part of a job so that they may finance the job. In some situations, these may be known as advance payments. They are nothing more than loans. They are treated as loans. They are secured by bank guarantees. Banks include them in the amount of credit risk they can have with a single client. They are routinely returned to the owner as a deduction from each monthly estimate—payment received by the contractor—so this loan is repaid in that way.

The method suggested by Treasury would tax these advance payments. They have suggested that they may amortize these over a 12-month period. Contracts generally last 2 to 3 years. A powerplant may go 5 years. A dam might go 5 years. But 2 to 3 years would certainly be a good average.

These are the main reasons that we oppose it. It would, in fact, tax liabilities rather than profits. And there is no reasonable reason for doing that sort of thing. It just doesn't make much sense to us. We are seeking abandonment of the proposal, Mr. Chafee.

The CHAIRMAN. I don't have any questions now. I think I would just say to the whole panel that obviously we are going to be working with your staff and with Treasury in trying to figure out something. We don't intend to abandon it. Obviously, nobody wants to pay taxes if they can avoid it legally. We understand that. If there is merit in the Treasury proposals, we will look closely at those proposals. I don't suggest that everything the Treasury does is not properly planned or ill thought out as Mr. Nolan has suggested. We will be hearing from Treasury, too.

[The prepared statement and the technical report follow:]

Testimony of William C. Daniels, Jr.

Mr. Chairman and Members of the Committee:

Good Morning, my name is William C. Daniels, Jr. I am Vice President and Treasurer of J. A. Jones Construction Company in Charlotte, North Carolina. Today I am testifying for the Associated General Contractors of America as Chairman of AGC's Tax and Fiscal Affairs Committee.

The Associated General Contractors of America (AGC) represents more than 30,000 firms, including 8,400 of America's leading general contracting companies which are responsible for the employment of more than 3,500,000 employees. These member contractors perform more than 80 percent of America's contract construction of commercial buildings, highways, industrial and municipal-utility facilities.

I am testifying today on a tax revision included in the Administration's 1983 proposed budget. The revision deals with the completed contract method of accounting for income tax reporting. It follows a study of the rules for long-term accounting methods announced last September and has been elaborated on in a Treasury General and Technical explanation released in late February of this year.

I would first like to give you a brief glimpse of the construction industry and the importance of the completed contract method of accounting to the industry.

The method was recognized as the appropriate accounting method for construction in Treasury regulations dating back to 1918 due to the unique nature and inherent risks in construction. Those inherent

RISKS AND THE UNIQUE NATURE OF CONSTRUCTION ARE AS GREAT AND AS MEANINGFUL TODAY AS THEY WERE SOME 64 YEARS AGO.

THEY INCLUDE DIFFERING SITE AND SOIL CONDITIONS; CLIMATE CONDITIONS; FIRM PRICES FOR THE DURATION OF THE CONTRACT WHICH REQUIRE THE CONTRACTOR TO BIND HIMSELF TO AN UNALTERABLE PRICE BEFORE ACTUAL COSTS ARE KNOWN; OWNER RETENTION POLICIES; CHANGES; MODIFICATIONS OR CLAIMS DURING THE COURCE OF THE CONTRACT WHICH REQUIRE THE CONTRACTOR TO EXPEND LARGE SUMS IN ADVANCE OF HIS CONTRACTUAL RIGHT TO COLLECT FROM THE OWNER; AND INTENSE COMPETITION WITHIN THE INDUSTRY WHICH FORCES PROFIT MARGINS TO BE EXCEEDINGLY SMALL IN RELATION TO THE TOTAL GROSS CONTRACT AMOUNT; AMONG MANY OTHERS.

THE UNIQUE NATURE AND INHERENT RISKS NECESSITATE THAT PROFIT, IF ANY, WILL BE KNOWN ONLY AFTER COMPLETION OF THE PROJECT WHEN THE OWNER HAS ACCEPTED IT AND ALL RETENTION HAS BEEN RETURNED THROUGH EVERY LEVEL OF THE GENERAL CONTRACTING AND SUBCONTRACTING PROCESS, AND EVEN THEN ONLY IF ALL CLAIMS AND DISPUTES HAVE BEEN SETTLED.

THE REASONS FOR CHANGE LISTED IN THE TREASURY DESCRIPTION OF ITS INITIATIVE ON LONG-TERM ACCOUNTING METHODS DO NOT INCLUDE ANY SIGNIFICANT PROBLEMS FOUND IN THE APPLICATION OF THE COMPLETED CONTRACT METHOD OF ACCOUNTING IN THE CONSTRUCTION INDUSTRY. ALL DISTORTIONS OF INCOME REPORTING, INCLUDING ANY IN INDIRECT COST PERIOD DEDUCTIONS, OCCUR AS A RESULT OF EXCEPTIONAL DURATION CONTRACTS (10-20 YEARS) WHICH ARE NON-EXISTENT IN THE CONSTRUCTION INDUSTRY.

IT IS NOT SURPRISING THAT THE REASONS FOR CHANGE ARE SILENT AS THEY APPLY TO THE CONSTRUCTION INDUSTRY, SINCE DISTORTIONS IN THE USE OF THE COMPLETED CONTRACT METHOD ARE NOT EVIDENT IN THE CONSTRUCTION INDUSTRY.

VIRTUALLY ALL CONSTRUCTION CONTRACTS HAVE RETAINAGE PROVISIONS. IN SOME INSTANCES THE RETAINAGE ARISES THROUGH A CONTRACTUAL PROVISION FOR PROGRESS BILLING; IN OTHERS THERE IS A SPECIFIC RETAINAGE OF A PERCENTAGE OF THE PORTION OF THE CONTRACT PRICE APPLICABLE TO WORK COMPLETED TO DATE. THE AMOUNT OF THE RETAINAGE IS ORDINARILY A VERY LARGE PART OF THE PROFIT TO BE REALIZED, AND IN MOST CASES IS EQUAL TO OR EXCEEDS THE TOTAL ESTIMATED PROFIT FROM THE CONTRACT. RETAINAGES ARE ALSO OFTEN USED FOR CORRECTION OR DEFECTS AFTER PROJECT COMPLETION. IN ALL CASES, RETAINAGE IS NOT RELEASED TO THE CONTRACTOR UNTIL AFTER PROJECT COMPLETION. CONSEQUENTLY, THE PROFIT ELEMENT OF A CONSTRUCTION CONTRACT IS NOT RECEIVED UNTIL RETAINAGE IS RELEASED.

FOR THE PAST 64 YEARS, THE COMPLETED CONTRACT METHOD HAS PROPERLY ALLOWED A CONSTRUCTION CONTRACTOR TO WAIT UNTIL CONTRACT COMPLETION AND ACCEPTANCE BEFORE DETERMINING INCOME TAX LIABILITY, THUS ENABLING FULL USE OF INTERIM PAYMENTS. THESE PAYMENTS MAY BE USED IN ANY BUSINESS FUNCTION AND MAKE UP A SIGNIFICANT PORTION OF WORKING CAPITAL, THE MOST SIGNIFICANT FISCAL CATEGORY IN CONSTRUCTION UNLIKE MANY OTHER INDUSTRIES.

THE INDUSTRY HAS LITERALLY MATURED AND GROWN IN RELIANCE ON THE COMPLETED CONTRACT METHOD AND THE RESULTANT USE OF WORKING CAPITAL. WORKING CAPITAL REPRESENTS LIQUID ASSETS WHICH A CONTRACTOR USES TO RUN HIS BUSINESS. IF SUFFICIENT LIQUID ASSETS ARE NOT AVAILABLE, THE CONTRACTOR MUST EITHER DEFAULT OR BORROW, IF ABLE, AGAINST THE VALUE OF OTHER ASSETS TO ATTEMPT TO CONTINUE ONGOING OPERATIONS.

THE CONSTRUCTION INDUSTRY IS A CONTRADICTION OF THE "GREATER THE RISK, GREATER THE RETURN" THEORY. FOR EXAMPLE, GENERAL CONTRACTORS IN THE COMMERCIAL SECTOR CAN EXPECT LITTLE MORE THAN A 1 PERCENT RETURN ON THEIR OPERATING REVENUES. CONSIDERING THIS MEAGER RETURN, MOST COMPANIES DO NOT HAVE ACCESS TO THE CAPITAL MARKETS AS A MEANS OF INCREASING THEIR EQUITY AND, IN FACT, HAVE GREAT DIFFICULTY IN OBTAINING LOANS TO SATISFY THEIR CASH REQUIREMENTS.

THE VAST MAJORITY OF CONSTRUCTION COMPANIES OPERATE IN A HIGH RISK, LOW RETURN ENVIRONMENT; THEY ARE BY MOST STANDARDS GREATLY UNDER CAPITALIZED AND MAINTAINING A SURVIVAL RATE OF CASH FLOW IS AN EVERYDAY WAY OF LIFE.

TO DISCARD THE COMPLETED CONTRACT, ACCRUAL AND CASH METHODS AS ACCEPTABLE ALTERNATIVES FOR INCOME TAX REPORTING WOULD CAUSE FURTHER SEVERE CASH SHORTAGES IN AN INDUSTRY ALREADY BESET WITH A LACK OF ADEQUATE CASH RESERVES. THE RESULTANT EFFECTS WOULD BE MASSIVE DEFAULTS OF CONTRACTORS AND SUBCONTRACTORS AND A CONTRACTION OF INDUSTRY PRODUCTION. THE RIPPLE EFFECT OF THIS CONTRACTION ON SERVICE AND MATERIAL SUPPLIERS TO THE CONSTRUCTION INDUSTRY WOULD BE STAGGERING.

AS I WILL EXPLAIN SHORTLY, THE TREASURY DEPARTMENT'S PROPOSAL WILL HAVE A SEVERELY DETRIMENTAL EFFECT ON THE CONSTRUCTION INDUSTRY DUE TO THE SWEEPING REVISIONS OF TRADITIONAL INCOME TAX REPORTING METHODS IT PURPORTS TO MAKE. OF THE INDUSTRIES CURRENTLY REPORTING INCOME TAX FROM LONG-TERM CONTRACTS, THE CONSTRUCTION INDUSTRY WILL BE THE MOST SEVERELY IMPACTED BECAUSE IT IS MADE UP OF THOUSANDS OF SMALL FIRMS. THESE SMALL FIRMS WILL FIND IT EXTRAORDINARILY DIFFICULT to administer the two tax accounting methods the Treasury proposes to require taxpayers to use if they have income from long-term contracts. One of these methods--the progress payment method--is an entirely new accounting method which fails to conform to any traditional theories of income taxation.

The Treasury Department's proposal is particularly unacceptable to the construction industry because regulations administering our tax reporting methods were thoroughly revised in 1976. At that time the Treasury had 58 years of experience in administering construction income tax reporting. We can find no significant reason for changing our tax reporting methods in the Treasury Department's explanation despite the fact the Treasury now has 64 years of history in administering construction income tax reporting now. The reasons for change described by Treasury all focus on extended duration contracts reporting under the completed contract method of accounting. Extended duration contracts were not a significant problem in completed contract method reporting regulations until 1976 when the regulations were revised. Income distortions found in those new industry users of the method can be corrected without affecting the construction industry and without any new legislation.

LEGISLATIVE PROPOSAL

The Treasury Department's proposal would eliminate three of the four methods of reporting construction contract income. Currently the construction industry uses the cash, accrual, percentage of completion and completed contract methods. The most important method is completed contracts. Cash and accrual are used by smaller firms

ESPECIALLY THOSE FIRMS ENTERING THE CONSTRUCTION INDUSTRY FOR THE FIRST TIME BECAUSE THEIR EASE OF ADMINISTRATION OUTWEIGHS THE HIGHER TAX LIABILITY THEY PRODUCE. THE PERCENTAGE OF COMPLETION METHOD IS BY FAR THE MOST COMPLICATED SYSTEM AND DUE TO A VARIETY OF TECHNICAL PROBLEMS AND THE INABILITY TO ACCURATELY ESTIMATE INCOME IS NOT WIDELY USED.

THE TREASURY WOULD CONTINUE TO ALLOW THE PERCENTAGE OF COMPLETION METHOD AND CREATE A NEW PROGRESS PAYMENT METHOD OF ACCOUNTING UNDER ITS PROPOSAL. THE PROGRESS PAYMENT METHOD IS AN ENTIRELY NEW CONCEPT, NOT BASED ON ANY KNOWN THEORY OF INCOME TAXATION. UNDER THE PROGRESS PAYMENT METHOD ALL CONTRACTS CURRENTLY SHOWING A POSITIVE CASH FLOW (PAYMENTS IN EXCESS OF EXPENDITURES) WOULD BE SUBJECT TO INCOME TAXATION OF THAT POSITIVE CASH FLOW. HOWEVER, NEGATIVE CASH FLOW CONTRACTS WOULD NOT OFFSET THIS TAX LIABILITY.

FAR MORE IMPORTANT, HOWEVER, IS THE FACT THAT CONTRACT LIABILITIES ARE IGNORED IN DETERMINING INCOME. CASH FLOW HAS NO RELATION TO "PROFIT" FOR INCOME TAX PURPOSES. INTERIM PROGRESS PAYMENTS DO NOT CONTAIN ANY ELEMENT OF PROFIT, AND THEY DO NOT DIRECTLY RELATE TO THE COST OF THE WORK PERFORMED BECAUSE OF VARIOUS CASH FLOW MANAGEMENT PRACTICES IN THE CONSTRUCTION INDUSTRY. WHATEVER PAYMENTS A CONTRACTOR MAY RECEIVE DURING A CONSTRUCTION PROJECT ARE SUBJECT TO HIS CONTRACTUAL LIABILITY TO PERFORM THE WORK OF THE CONTRACT. NO TRADITIONAL THEORY OF INCOME TAXATION WOULD ALLOW A TAX LIABILITY TO BE DETERMINED WITHOUT REFERENCE TO LIABILITIES. THIS IS A FATAL FLAW OF THE PROPOSED PROGRESS PAYMENT METHOD OF ACCOUNTING WHICH WE BELIEVE TO BE INSURMOUNTABLE.

The percentage of completion method is a complex accounting procedure, as I mentioned earlier. According to the Treasury Department's own explanation it is an estimate of profit. As an accounting method it only measures work completed. All the inherent risks of the construction process, material installation, weather, soil conditions, etc., cannot be measured under the method. As a result, the method is not an acceptable alternative.

The completed contract method is the dominate tax reporting method in construction because it is fair, equitable and most importantly, accurate. Contract costs and profit are determined when a project is completed and accepted. No gain or loss is recognized for income tax purposes until contract completion and acceptance. The method precedes the income tax as the appropriate financial accounting method for construction projects. Its use for income tax reporting was recognized first in Treasury Department regulations published in 1918 pursuant to the 1916-17 Revenue Acts. As I mentioned earlier, the completed contract regulations were fully revised in 1976 after several sets of proposed regulations were published and commented on by the industry from 1971-1976. We believe that the regulations properly reflect construction contract income and that the regulations, as well as the completed contract method of accounting, must be preserved so far as they apply to the construction industry.

REGULATORY PROPOSAL

Included in the Treasury Department's proposal are a variety of changes to the regulations implementing the completed contract

METHOD OF ACCOUNTING. SOME OF THESE REGULATORY CHANGES ARE DESIGNED TO IMPLEMENT THE LEGISLATIVE PROPOSAL WHILE OTHERS WOULD DRASTICALLY CONFUSE THE ADMINISTRATION OF THE COMPLETED CONTRACT METHOD OF ACCOUNTING, INDEPENDENT OF ANY LEGISLATIVE CHANGES.

THE COMPLETED CONTRACT METHOD OF ACCOUNTING WAS SUBJECT TO A MAJOR REGULATORY REVISION IN 1976. THE REGULATIONS WERE PUBLISHED AFTER A FIVE-YEAR COMMENT PERIOD ON SEVERAL PROPOSED REGULATIONS STARTING IN 1971. THE RULES WORKED OUT IN IMPLEMENTING THE COMPLETED CONTRACT METHOD OF ACCOUNTING AS IT APPLIES TO THE CONSTRUCTION INDUSTRY WERE BASED ON 58 YEARS OF EXPERIENCE DEVELOPED IN THE TREASURY AND IRS. WITHOUT ANY SIGNIFICANT REASON FOR CHANGE, THE TREASURY HAS PROPOSED A WHOLESALE REVISION OF THE TECHNICAL RULES FOR ADMINISTERING THE COMPLETED CONTRACT METHOD OF ACCOUNTING.

THE PRINCIPAL CHANGES AS THEY AFFECT CONSTRUCTION ARE FOUND IN THE ALLOCATION OF INDIRECT COSTS. THERE ARE 27 CATEGORIES OF INDIRECT COSTS. UNDER CURRENT REGULATIONS 14 ARE ALLOCATED TO THE CONTRACT (DEDUCTED AT CONTRACT COMPLETION). THIRTEEN COST FACTORS ARE DEDUCTED CURRENTLY AS A REFLECTION OF CURRENT BUSINESS OPERATIONS EXPENSES WHICH ARE NOT APPROPRIATELY ALLOWABLE TO ANY CONTRACTS. THE EXISTING PERIOD COST DEDUCTIONS REFLECT A FIVE-YEAR DIALOGUE BETWEEN TREASURY AND INDUSTRY REGARDING A DETERMINATION OF APPROPRIATE AND VALID ALLOCABLE COSTS AND CURRENT COSTS. THE VALIDITY AND APPROPRIATENESS OF THESE PERIOD COSTS HAVE NOT CHANGED IN THE FIVE SHORT YEARS SINCE THEIR ENACTMENT, AND SHOULD NOT NOW BE REVISED.

I WOULD LIKE TO REITERATE THAT THE REASONS FOR CHANGE IDENTIFIED BY THE TREASURY IN ITS GENERAL AND TECHNICAL EXPLANATION APPLY TO CONTRACTS OF EXTENDED DURATION. WE BELIEVE THAT CERTAIN CHANGES TO THE REGULATIONS CAN BE MADE WITHOUT AFFECTING THE HISTORIC AND TRADITIONAL APPLICATION OF THE METHOD AS IT APPLIES TO CONSTRUCTION. THESE CHANGES DO NOT REQUIRE NEW LEGISLATION OR MODIFICATION OF THE METHOD AS IT APPLIES TO CONSTRUCTION.

IN ADDITION TO MY TESTIMONY, I WOULD LIKE TO SUBMIT A FULL TECHNICAL ANALYSIS OF THE ISSUE FOR THE RECORD WHICH WE HAVE ALREADY GIVEN TO THE TREASURY DEPARTMENT.

THANK YOU.

COMMENTS ON FEBRUARY 26, 1982 DEPARTMENT OF TREASURY GENERAL/TECHNICAL EXPLANATION REGARDING THE COMPLETED CONTRACT METHOD OF ACCOUNTING

General Comments

The completed contract method of accounting allows a taxpayer to wait until the contract is completed and accepted before reporting income from the contract. The accounting method is a traditional construction accounting technique which precedes the income tax. Its use was recognized for income tax purposes in regulations published in 1918 which implemented the 1916-17 Revenue Acts. It was recognized as the appropriate accounting method for construction due to the unique nature and inherent risks in construction. Those inherent risks and unique nature are as great and as meaningful today as they were some 60 years ago.

They include differing site and soil conditions; climate conditions; firm prices for the duration of the contract which require the contractor to bind himself to an unalterable price before actual costs are known; owner retention policies; changes; modifications or claims during the course of the contract which require the contractor to expend large sums in advance of his contractual right to collect from the owner; and intense competition within the industry which forces profit margins to be exceedingly small in relation to the total gross contract amount; among many others.

This unique nature and inherent risks necessitate that profit, if any, will be known only after completion of the project when the owner has accepted it and all retention has been returned through every level of the general contracting and subcontracting process, and even then only if all claims and disputes have been settled.

The reasons for change listed in the Treasury description of its initiative on long-term accounting methods do not include any significant problems found in the application of the completed contract method of accounting in the construction industry. All distortions of income reporting, including any in indirect cost period deductions, occur as a result of exceptional duration contracts (10 - 20 years) which are non-existent in the construction industry.

It is not surprising that the reasons for change are silent as they apply to the construction industry, since distortions in the use of the completed contract method are not evident in the construction industry. The distortions that are evident by other users of the method could be limited by simply modifying Section 1.451(e)(i) to provide a basis for severing long-term production contracts by units of delivery and acceptance or some other similar arrangement, without concommitantly penalizing the construction industry's use of the method.

Specific Comments on Treasury Department General/Technical Explanation

Progress Payment Method

1) The proposal is noting "that taxpayers must elect to use either the percentage of completion method or the progress payment method of accounting for long-term contracts" eliminates not only the completed contract method but the cash and accrual methods as well. Since many construction companies take the form of proprietorships, partnerships, Subchapter S Corporations as well as regular corporations, many construction companies keep their books on one of these two methods for both financial and tax reporting. Eliminating these two options, in addition to the completed contract option, from use by construction companies would be arbitrary, capricious and punitive, particularly since cash and accrual will still be available for other taxpayers. Additionally, since the cash and accrual methods tend to cause income to be reported earlier than either the percentage of completion or the completed contract method, the proposal would actually result in a reduction of tax revenues.

2) The proposed progress payment method deviates from all traditional theories of business entity taxation, i.e. taxation of profits, by imposing a tax on positive cash flow independent of any reference to concurrent liabilities.

3) The proposed progress payment method would result in the taxing of receipts when, in fact, no income had actually been earned. It would also not permit the offset of losses calculated on the same basis, thus requiring that each contract be treated as a separate and complete "company" with no consolidation for income tax purposes. A medium sized general contractor might have between 20 and 40 open contracts in progress at any one time. To require the payment of taxes on contracts with positive cash flow while disallowing a reduction in taxes for contracts with negative cash flow would cause a cash drain that would be certain financial death. In the construction industry, each contracting company is operated as a whole, not on a project-by-project basis.

4) The proposal is based on a misunderstanding of the construction industry's operating method. Interim progress payments do not contain any element of profit, and they do not directly relate to the cost of the work performed because of various cash flow management practices in the construction industry notably; mobilization payments, contract advances, and higher monetary value of work performed in the early stages of a construction project.

   a) Mobilization advances represent a recognition by the owner that there are capital costs in the early phases of a construction project that cause a heavy strain on a contractor's financial structure. Generally, the amount of the mobilization advance is determined during the bidding process by taking value from certain activities and adding the value to the mobilization pay item. To tax the mobilization payment as income overlooks the fact that the contractor must still perform the work before he has earned any profit. The depreciation or amortization of capital or life of contract expenditures, like bond premiums, can only be charged to cost overtime. Some contracts that have mobilization advances are, in fact, completed at a loss for the overall contract. The proposal could result in a contractor being required to pay a tax on mobilization advance on a project that ultimately shows no profit and not being able to recover the tax payment for two or three years.

b) Contract advances are a recognition by the owner of the cost of acquiring large amounts of construction equipment and, on foreign projects, of the cost of shipping it to a foreign country and the risk of making large investments in countries that may have unstable governments. These advances are nothing more or less than secured loans. They are secured by irrevocable letters of credit (some of which may require compensating deposits of a part of the contract advance), bank guarantees or surety bonds and must be repaid over the life of the project by prorated deductions from progress billings. Taxing contract advances is tantamount to taxing working capital loans.

c) Unbalanced bidding and front-end loading are two cash flow management practices which place a higher monetary value on work performed in the early stages of a construction project with a concommitant reduction in the monetary value of work performed in later stages of the project. These cash flow management practices are used to insure recovery of fixed costs and reduce the amount of outside financing necessary for the project thus reducing the overall price for the project. It must be emphasized again, however, that improved cash flows are not profits and do not directly relate to the cost of the work performed.

The treatment of such payments is inadequate in the technical explanation. Such payments are the rule and not the exception in the construction industry, and will result in an inundation of requests for extended prorated periods for treatment of such payments. In addition, these payments are used for purposes which do not result in offsetting tax deductions due to the type of expense for which the cash is used, e.g. collateral for lines of credit, equipment depreciation over periods longer than a year. As a result, basing tax liability on temporary positive cash flow created by these payments, reduced only by current deductible liabilities, would grossly distort income.

5. Further evidence that progress billings do not represent earnings is the concept in accounting literature of treating progress billings in relation to cost and earnings. Under Generally Accepted Accounting Principles (GAAP) when utilizing the percentage of completion method, progress billings in excess of

cost and earnings (determined by applying one of the accepted earnings' calculations) must be reflected in the balance sheet as a liability and where cost and earnings are in excess of billings, they must be reflected in the balance sheet as an asset. The proposal would tax the liability (excess billingS) but would not allow an offset of the asset (excess costs).

6) The proposal states that the new provisions intend to reduce "the tax advantages available to taxpayers who are able to use the completed contract method." The apparent intent of the provision is to place contractors on the same basis as a manufacturer reporting taxes currently. Yet the proposal states that if a contractor begins two contracts during a year, one showing a profit and one showing a loss, using the "Progress Payments Method" there would be no offsetting of profit and loss on the two contracts. The manufacturer is allowed to offset gains and losses on the sale of his units and in fact will often use "loss leaders" to encourage sales. Furthermore, the manufacturer is not forced to allocate all overhead expenses to inventory since present regulations allow for a practical capacity level for purposes of allocation recognizing that not all indirect costs are allocable. Manufacturers are further allowed to elect LIFO as a method of valuing their inventory which allows them a permanent deferral as compared to a deferral under the completed contract method. A manufacturer can alternatively elect to value inventory at the lower of cost or market which allows a write off of expense even before a sale is made and realization of the loss.

Period Cost Deductions

7) A wholesale revision of the period cost deductions is not necessary or warranted. Providing contract segregating rules for extended duration manufacturing and other production type contracts which construction is not, would drastically lessen the inflation effect of current period deductions. For example, the inflation effect of currently (1982) deductible pension and profit sharing plan contributions are significantly higher in economic value when the income being reported is from a 1970 contract rather than a 1980 contract.

The present period cost deductions were developed between 1971 and 1976 when the IRS issued three sets of proposed regulations. The final regulations were published after strong industry protest to earlier regulations which attempted to require conformity between financial and tax accounting. The existing period cost deductions reflect a five year dialogue between Treasury and industry regarding a determination of appropriate and valid allocable costs and current costs. The validity and appropriateness of these period costs have not changed in the five short years since their enactment, and should not now be revised.

Revision of the period costs as proposed in the technical explanation would not reflect the realities of the construction industry. Examples include:

a) Interest allocation to contracts is often impossible to determine due to the general practice of borrowing money for general working capital purposes for a number of open contracts. These loans would be difficult to trace to individual contracts in exact proportions due to the variety of billing and advance payment practices in the industry. Interest allocation as a result of equipment purchases would similarly be impossible, since a piece of equipment could be used on 20, 30, or any number of contracts during a year. In addition, interest income is not allocated to long-term contracts. Requiring interest expense allocations for deferral recognition would, in our view, also require allocation.

b) The proposal determines that all general and administrative expenses can be allocated, which is unrealistic. One general guideline in the past for distinguishing between job costs and period cost is that costs allocable to the contract must be incurred "incident to and necessary" for the performance of the long-term contract. This phrase is taken from the regulations under Section 471 relating to inventory costing. Under such regulations a production cost must be incurred incident to and necessary for production in order to be considered an inventoriable cost. The proposal appears to have singled out the construction industry and stated that other than the list suggested all other general and administrative expenses are incident to and necessary to specific contracts, when in fact these expenses are impossible to rationally allocate to any given contract.

For example, janitorial expenses are not a cost which can be allocated to a contract in any administrable manner since it is a necessary cost for all business operations. Certain compensation, legal and accounting expenses, public relations, among many others, present similar problems.

c) Under the proposal accelerated depreciation would be an allocated cost attributable to a particular long-term contract. While the Treasury Department may feel that this expense can be properly allocated to a particular job, which is a dramatic change from existing tax law, such allocation is virtually impossible. A large contractor may have a fleet consisting of thousands of individual pieces of equipment many of which may work on many different jobs during a year. Many contractors allocate equipment by the use of a pool of equipment concept where all equipment costs are accumulated and then billed to individual jobs at a rate sufficient to recover the cost of each piece of equipment on a straightline basis over its estimated hours of production. The rate used for charging equipment to jobs based on the hours of use on the particular project has depreciation expense computed on a straightline basis. The net result of unallocated equipment expense not charged to jobs will be the result of accelerated depreciation and idle time on equipment during the year as currently allowed by regulation. The allocation of expense to jobs is always at best an estimate and never an exact method.

d) The proposal would also require the allocation of pension and profit sharing expenses representing current service costs as allocable to specific construction contracts. An employee may work on many different contracts during a particular year and in the case of a profit sharing contribution the actual amount credited to an employee may not be determined until long after a year ends. An allocation to specific jobs on any type of current basis would be virtually impossible. Furthermore, an employee may be only partially vested in his pension and profit sharing account and if he left the employ of the company would forfeit part of his allocation. Does the Treasury envision an adjustment to closed jobs in future years for forfeitures lost by an employee reallocated to current employees working on current jobs? As can be seen the burden of accomplishing the allocation would be impossible.

Impact of Proposed Changes on the Construction Industry

Construction variables not found in other industry users of the completed contract method include working on different sites which are not controlled by the contractor for each project; variable weather and soil conditions for each construction project; a diversified labor structure which must be coordinated; payment retentions by an owner; changes, modifications, or claims during the contract term which require the expenditure of large sums by the contractor before the contractual right to collect from the owner;

intense competition in the industry which creates extremely narrow profit margins in relation to gross contract amounts. These variables necessitate that profit on a construction contract is not known until contract completion and acceptance.

Large sums must be expended by a contractor in advance of his contractual right to collect from his client. Because of the large total contract sums involved, this stretches the financing capacity of construction contractors on a regular basis.

Virtually all construction contracts have retainage provisions. In some instances the retainage arises through a contractual provision for progress billing; in others there is a specific retainage of a percentage of the portion of the contract price applicable to work completed to date. The amount of the retainage is ordinarily a very large part of the profit to be realized, and in most cases is equal to or exceeds the total estimated profit from the contract. Retainages are also often used for correction of defects after project completion. In all cases, retainage is not released to the contractor until after project completion. Consequently, the profit element of a construction contract is not received until retainage is released.

For the past 60 years, the completed contract method has properly allowed a construction contractor to wait until contract completion and acceptance before determining income tax liability, thus enabling full use of interim payments. These payments may be used in any business function and make up a significant portion of working capital, the most significant fiscal category in construction unlike many other industries.

The industry has literally matured and grown in reliance on the completed contract method and the resultant use of working capital. Working capital represents liquid assets which a contractor uses to run his business. If sufficient liquid assets are not available, the contractor must either default or borrow, if able, against the value of other assets to attempt to continue ongoing operations.

The construction industry is a contradiction of the "greater the risk, greater the return" theory. For example, general contractors in the commercial sector can expect little more than a 1 percent return on their operating revenues. Considering this meager return, most companies do not have access to the capital markets as a means of increasing their equity and, in fact, have great difficulty in obtaining loans to satisfy their cash requirements.

The vast majority of construction companies operate in a high risk, low return environment; they are by most standards greatly under capitalized and maintaining a survival rate of cash flow is an everyday way of life.

To discard the completed contract, accrual and cash methods as acceptable alternatives for income tax reporting would cause further severe cash shortages in an industry already beset with a lack of adequate cash reserves. The resultant effects would be massive defaults of contractors and subcontractors and a contraction of industry production. The ripple effect of this contraction on service and material suppliers to the construction industry would be staggering.

The following actual cases and examples will serve to illustrate some of the effects on the industry: Company A is a small general contractor with operating revenues of approximately $4 million in 1979, which increased to approximately $8 million in 1981. Its condensed balance sheet at December 31, 1979 is as follows:

CONDENSED BALANCE SHEET
Company A
12/31/79

Current Assets	$870,000	Current Liabilities	$700,000
Other Assets	61,000	Shareholders' Equity	231,000
Total Assets	$931,000	Total Liabilities & Equity	$931,000

At December 31, 1979, the company had a contract which was 40 percent complete and had received payments in excess of contract costs of $245,000, which under the progress payment method would have resulted in taxes payable of approximately $112,000. During calendar year 1980, the contractor encountered severe problems with the project which resulted in projected significant losses in 1980 and 1981, culminating in a total loss of $940,000 at December 31, 1981. Also during 1980 the contractor began work on additional projects and at December 31, 1980, the condensed balance sheet is as follows:

CONDENSED BALANCE SHEET
Company A
12/31/80

Current Assets	$1,400,000	Current Liabilities	$1,274,000
Other Assets	1,000	Shareholders' Equity	127,000
Total Assets	$1,401,000	Total Liabilities & Equity	$1,401,000

At December 31, 1980, the company had other projects on which payments in excess of cost equaled $575,000 which under the progress payment method would have resulted in an additional tax payable of approximately $265,000.

Under the proposed progress payments method, the contractor would have paid taxes as follows:

12/31/79	$112,000
12/3180	265,000
	$377,000

At this point in time, the contractor cannot pay the income taxes out of the company's working capital, which is now negative, and cannot get a loan based on the financial statements of the company. The company is, in fact, probably out of business.

Fortunately, the completed contract method more accurately reflected the results of all contracts, and the company paid no taxes in 1979 and 1980. The company was able to survive and during calendar year 1981 had operating revenues of approximately $8 million on which it was able to derive acceptable profits.

Company B has a deferred tax liability of $5 million of which under the completed contract method $2.5 million is payable at the end of its current fiscal year. Company B also has a net worth of $6 million and working capital of $8 million. A bonding company considers net worth and working capital in determining the amount of work in progress it will permit Company B. The bonding company also considers deferred taxes not to be paid in the current year as a reduction in current liabilities, thereby increasing working capital. In this instance, $2.5 million not due in the current year is deducted from current liabilites, increasing working capital by $2.5 million, from $8 million to $10.5 million. The bonding company will allow $20 of work in progress for each dollar of working capital. Under these circumstances, the bonding company will permit work in process of $210 million ($10.5 million times 20); however, if under the percentage of completion or the progress payment method, Company B must pay an additional $2.5 million in income taxes, then the bonding company will in this case reduce the amount of work in process allowed approximately $50 million ($2.5 million times 20) or from $210 million to $160 million.

In a work program consisting of $210 million, work in progress, total operating revenue for a fiscal year would be in the range of $150 million and if the General Contractor is doing 40 percent of the work with his own forces, the contractor would be employing approximately 800 employees. If the contractor's volume is thus reduced approximately 25 percent ($50 million divided by 210), then 200 of his 800 employees would become unemployed. Likewise, the approximately 1,200 subcontract employees would be reduced by 300 employees.

The reduction in the work force of the general contractor and of the subcontractor does not take into account the ripple effect on the hundreds of material and service suppliers to the general contractor and the subcontractors.

In addition, the proposals would not be without an immense administrative burden. The proposed progress payment method would necessitate the creation of a whole new set of books for tax purposes.

At the present time a conversion to the completed contract method can be accomplished simply by the reporting of completed contracts and the continued accumulation of jobs in progress. The conversion of all contracts to the "progress payment method" for revenues and the proposed allocation of expenses would be an unrealistic burden. In addition to the burden of establishing the new method of reporting, the audit of returns by the Internal Revenue Service under the progress payments method would be almost impossible. Actual experience on examination under the completed contract method of accounting substantiates the problems that IRS auditors would have using hindsight in the audit of returns under the "progress payment method." Most auditors would not have the time to verify the adjustments to revenue and expenses on each contract nor realistically be in a position to question the proposed arbitrary allocations. Upon audit, persuading the IRS agent that a correct method of allocation was used would open a whole new area of investigation and litigation. Currently, the IRS regulations are clear on what indirect costs would be allocated and those that are not required to be included in costs attributable to a long-term contract. In addition to the problem of a method of allocating indirect costs, there exists the problem of accounting for such an allocation. Financial accounting methods impose the requirement that indirect costs cannot be allocated to the cost of a contract. Indirect costs are considered period costs and should be deducted currently. The proposed amendments would require the maintenance of separate sets of books to allocate these indirect costs to long-term contracts. Many small and medium sized contractors and subcontractors simply do not have the administrative staff or professional accountants to keep track of all these allocations. The mere cost of record keeping and compliance could cause them to go out of business.

Summary

1) There are no valid reasons for limiting the use and/or availability of the completed contract method of accounting in the construction industry. Distortions in the use of the completed contract method are not evident in the construction industry. The distortions that are evident by other users of the method could be limited by simply modifying Section 1.451-3(e)(i) to provide a basis for severing long-term production contracts by units

of delivery and acceptance or some similar arrangement.

2) Application of the proposed changes to the construction industry would severly penalize the industry for other users distortions of the completed contract method. Restricting working capital in the construction industry by imposing a tax on interim contract proceeds, which will occur under any method other than the completed contract method, will result in defaults, reduction in the scope of a contractor's business operations, and forcing the industry as a whole to seek more outside financing for its projects, an action that may not be economically feasible in the current economic climate.

3) There must be no change in the availability or use of the completed contract method in the construction industry.

STATEMENT OF LESLIE J. SCHNEIDER, THE COMMITTEE TO PRESERVE THE COMPLETED CONTRACT METHOD, WASHINGTON, D.C.

The CHAIRMAN. Mr. Schneider, you are next. Who belongs to the Committee to Preserve Completed Contract Method? Do you have a list of your membership?

Mr. SCHNEIDER. Yes, we do, and we are prepared to submit that. It's about a dozen companies in a variety of fields.

Mr. Chairman and members of the committee, my name is Leslie J. Schneider. I'm an attorney with the Washington, D.C., law firm of Ivins, Phillips & Barker. I am testifying today in my capacity as counsel to a newly formed organization entitled the "Committee to Preserve the Completed Contract Method."

Our committee was organized to represent the interests of a number of companies in diverse areas that will be affected by this proposal. Those areas include shipbuilding, scientific and precision instruments, defense, aerospace, commercial construction, industrial construction, and residential construction. The reason that this committee was formed was to present a unified view of the variety of industries that will be affected. There was a concern that many companies that will be testifying and the many speakers that will testify represent the point of view of one industry, or one point of view. The feeling of the members of this group is that the proposals by the Treasury Department affect a broad range of companies in a variety of industries. And for that reason, we felt it necessary to organize this group.

The thing that troubles our committee greatly is the spirit in which these proposals were made. The Treasury Deparment and the administration indicated that they are not interested in fundamental tax reform, but in closing loopholes. What greatly distresses this committee is that what we are dealing with here is not loopholes. And speaking personally for myself, my feeling is that I should know. I helped write the rules some 10 years ago. As a professor of tax accounting and as an author of several treatises in this field, I have studied this area for 10 to 12 years. It's my personal view that the rules that presently exist in accounting for long-term contract were extremely well thought out. They are totally consistent with the rules and regulations that apply in all areas of the Code in reporting income and expenses. To categorize them as loopholes is to totally mislabel the problems which I think the Treasury and the administration seek to address.

The rules and the regulations that we have here have been in existence for over 60 years. They were extremely well thought out and developed through——

Senator CHAFEE. That's not quite accurate, Mr. Schneider. It's my understanding that the completed contract cost accounting system didn't come until—what did somebody say—8 years ago. Prior to that, was the Treasury taxing on the—without this method of accounting?

Mr. SCHNEIDER. That is not correct Senator Chafee. Having been employed at the Treasury at that time and being familiar with the correspondence between the Treasury and the Congress at that time, it's clear that prior to 1976 there were precisely the same rules for costing long-term contracts that there are now. The regulations did not contain those rules, but they were embodied in case law and rulings. All the Treasury did was to elevate those rules to the status of regulations. They did not change the rules.

The CHAIRMAN. I think they expanded them.

Mr. SCHNEIDER. Not in the costing area. They expanded them somewhat in the area of who would be eligible to use the completed contract method but not in how those contracts were costed.

Senator CHAFEE. Now, Mr. Nolan, were your firms using it prior to 1976?

Mr. NOLAN. Some firms were and some were not. That was part of the problem that was addressed in 1971 when the regulations were proposed. That there were enormous difficulties because some companies were using this method; some were not. And there was no rational basis on which the decision was made. So all of that was incorporated in proposed regulations in 1971. A great deal of that effort went into figuring out the costing rules, as Mr. Schneider has said. A lot of conferences with Treasury, with the IRS, with the joint committee staff, and then the regulations were done in a comprehensive and thoughtful way.

Senator CHAFEE. OK. Mr. Schneider.

Mr. SCHNEIDER. I think the thing that troubles everyone is that it is an extremely and complex technical area. But if you really get down and examine the way in which the typical construction contractor is taxed, you will find such contractor is taxed in precisely the same way that any taxpayer in the United States, using the accrual method, is taxed. He performs work. And when the work is completed, he pays income tax on his gain on that transaction.

We do not take an automaker, we do not take a roadbuilder, we do not take anyone in any other field who is manufacturing a product and say that when he is one-third done or one-half finished with the manufacture of that product that he has earned one-third of the income or he has earned one-half of the income. And that's generally true even where he receives the money up front. You go out and you purchase some furniture from a furniture manufacturer and you give the furniture manufacturer a deposit. The furniture manufacturer does not pay income taxes on that deposit until the contract is completed, just as a completed contract taxpayer would not in the defense area or in the construction area.

So I think the problem we have is that the rules, as they apply to the completed contract industry, are precisely the same rules that apply to every other taxpayer. Perhaps it is unfortunate in the sense that some contracts take longer than others to complete, and, therefore, there may be a gap in time between the receipt of this money, and the time when taxes are paid. But that's precisely the case in every other industry.

Senator CHAFEE. Any abuses ever take place?

Mr. SCHNEIDER. Yes, but to the extent that they are abuses, they involve people that are not following the regulations as they are now written. To the extent that contracts may extend over 10 or 20 years because really more than one contract is involved, the existing rules adequately take care of that if they were so interpreted. To the extent that taxpayers are deducting more cost as they go along than they are entitled to, it's not a function of the regulations being wrong, it's a function of more effective audits to detect taxpayers that are categorizing the costs in a way that is not consistent with the regulations.

Senator CHAFEE. OK.

Mr. SCHNEIDER. In summary, our view is that this Committee should direct the Treasury and the Internal Revenue Service to withdraw their proposals both in the legislative and regulatory areas, and concentrate on publishing rulings that clarify those areas that are ambiguous or currently abused. We do not believe that the law needs to be changed.

[The prepared statement follows:]

PROPOSED TESTIMONY
BEFORE SENATE FINANCE COMMITTEE

Technical Memorandum

COMMITTEE TO PRESERVE COMPLETED CONTRACT METHOD

My name is Leslie J. Schneider. I am an attorney with the Washington, D. C. law firm of Ivins, Phillips & Barker. I am the author of the treatise, Federal Income Taxation of Inventories (3 Vols. Matthew Bender) and numerous articles and publications dealing with tax accounting matters and long-term contracts. I have also been an Adjunct Professor of Federal Tax Accounting in Georgetown University Law Center's Master of Taxation program.

Prior to joining Ivins, Phillips & Barker in 1973, I was an attorney and accountant adviser in the Office of Tax Legislative Counsel. I was one of the principal draftsmen of the long-term contract regulations (Reg. § 1.451-3), advance payment regulations (Reg. § 1.451-5), and the full absorption inventory regulations (Reg. § 1.471-11).

I am testifying in my capacity as Counsel to a newly-formed organization, entitled the "Committee to Preserve the Completed Contract Method." Accompanying me is Michael F. Solomon, Assistant Counsel.

The committee consists of a number of companies in such diversified areas as shipbuilding, scientific and precision instruments, defense, aerospace, and commercial, industrial and residential construction. The principal goal of the committee is to present the view of the full range of companies that will be adversely affected by the Administration's proposals to drastically alter the tax accounting rules for long-term contracts.

I. INTRODUCTION

In the President's State of the Union Message on January 26, 1982, the President indicated that the Administration was committed to the tax cut program enacted by the Congress as part of the Economic Recovery Tax Act of 1981. The President stated that his Administration would not pursue a broad-based effort to raise taxes; instead, the Administration is on record that it will concentrate its tax reform effort "to eliminate abuses and to remove obsolete incentives." It is in this context that the Administration has proposed the total elimination of the completed contract method, as well as the traditional accrual method of accounting, for long-term contracts and to incorporate certain period costs on existing long-term contracts as a tax preference item in the new proposed minimum tax on corporations.

The committee is unequivocally opposed to the Administration's long-term contract proposals. The Administration's explanation of the proposals inaccurately portray the present tax accounting rules for taxpayers with long-term contracts as an unintended loophole. Furthermore, the Administration's proposals would unfairly discriminate against taxpayers with long-term contracts by placing them in a less competitive position than taxpayers without long-term contracts in other industries.

The central thesis of the committee's testimony is that:

1) The present rules of accounting for long-term contracts have been a part of our tax laws for over 60 years. These provisions were adopted after careful consideration and after consultations with members of Congress and their staffs, and do not provide an unintended loophole;

2) The tax accounting rules which apply to taxpayers with long-term contracts are comparable to those which apply to most other taxpayers. The Administration's proposals would drastically alter such symmetry; and

3) The particular abuses which the Administration seeks to redress could easily be resolved under the existing law by more effective audit enforcement and by the promulgation of clarifying revenue rulings which interpret the present law. The Administration's proposals represent a classic case of overkill, by eliminating the entire body of statutory, regulatory and judicial law developed over the past 60 years.

The subject of tax accounting is technical and complex. In order to have a complete understanding of this subject and in order to properly evaluate the Administration's proposals, it is essential to place the present tax accounting rules for long-term contracts in their historical perspective. Accordingly, this technical memorandum sets forth below a detailed analysis of the historical development of the present tax accounting rules for long-term contracts. In addition, the various reasons why the Administration's proposal in this area should not be adopted are further developed in subsequent sections of this memorandum.

II. HISTORICAL DEVELOPMENT OF THE COMPLETED CONTRACT METHOD

In regulations dating back to 1918, the Internal Revenue Service has permitted two specialized methods of accounting to be used for long-term contracts: (1) the completed contract method; and (2) the percentage of completion method. Article 121, Reg. § 33 (1918) provided for the reporting of income by contracting corporations as follows:

> "Art. 121. Contracting corporations. -- Corporations engaged in contracting operations and which have numerous uncompleted contracts, which in some cases run for periods of several years, will be allowed to prepare their returns so that the gross income will be arrived at on the basis of completed work -- that is, on jobs

which have been finally completed -- any and all moneys received in payment for completed jobs will be returned as income for the year in which the work was completed. If the gross income is arrived at by this method, the deduction from gross income should be limited to the expenditures made on account of such completed contracts.

"Income on basis of estimates. -- Or the percentage of profit from the contract may be estimated on the basis of percentage of completion and payments made thereon, in which case the income to be returned each year during the performance of the contract will be computed upon the basis of the expenses incurred on such contract during the year; that is to say, if one-half of the estimated expenses necessary to the full performance of the contract are incurred during one year, one-half of the gross contract price should be returned as income for that year; all under or over statements of income to be adjusted upon completion of the contract and return made accordingly. (T.D. 2161.)

"In cases wherein contracts are fully performed in one year, although payment therefor may be deferred until the next, the income resulting from the performance of the contract shall

> *be returned for the year in which it was actually* earned and determined."

The availability of these specialized methods of accounting have also received the support of the courts. See Ehret-Day v. Comm., 2 T.C. 25 (1943); Rice, Barton & Fales, Inc. v. Comm., 41 F.2d 339 (1st Cir. 1930); Badgley v. Comm., 21 BTA 1055 (1931), aff'd 59 F.2d 203 (2nd Cir. 1932); and James C. Ellis v. Comm., 16 BTA 1225, wherein the Board stated:

> "But the petitioners say that the article just quoted is invalid, since it permits a taxpayer to report on a basis that does not fairly reflect his income, and that, therefore, an election made under authority of the article is not binding. We cannot agree with that argument. It is true that returning income on the completed contract basis may result in a larger income in a given year than would be reported for the same year were the profit spread over the entire term in which the contract was performed. But it seems to us that the former method of returning the profit from a long-term contract is no more likely to result in distortion of income than the latter method. For example, a contract covering a period of two years may show a profit at the end of the first year based on receipts and expenditures

> at that time, whereas the contract when completed may result in a loss. The completed contract basis will always reflect the gain or loss from the contract as a whole, while the other method may result in a gain being reported in one year when the contract terminates in a loss, or a loss being reported when a gain finally is realized. The regulation in question is designed to reflect income from long-term contracts, and we are unable to perceive that it is inconsistent with or is not authorized by law. In re Harrington, 1 Fed. (2d) 749." 16 BTA at 1228.

The specialized long-term contract methods are not, however, mandatory. Thus, taxpayers with long-term contracts are permitted to use the accrual method and, in some cases, the cash method. See Reg. § 1.451-3; G.C.M. 22682, 1941-1 C.B. 307; and C.A. Hunt Engineering Co., Inc. v. Comm., 15 T.C.M. 1269 (1956).

Under the completed contract method, no revenues or expenses directly related to a long-term contract are included in taxable income until the contract is finally completed and accepted. Reg. § 1.451-3(b)(2). Under the percentage of completion method, the expenses of performing the long-term contract are currently deductible and that portion of the contract price reflected by the percentage of the contract which is completed during the taxable year must be included currently in gross revenues. Reg. § 1.451-3(c). Under both of these methods, progress payments received prior to the completion of the contract do not enter into the determination of any such taxpayer's taxable income. Reg. § 1.451-5(b)(3); Reg. § 1.451-3(c); Reg. § 1.451-3(d)(1).

In practice, the completed contract method has proved to be the more prevalent method. It enables taxpayers with long-term contracts to conserve working capital during the construction period and produces a precise matching of revenues and expenses and a corresponding determination of taxable income directly attributable to each long-term contract. The rationale for the availability of such method has been explained by the Internal Revenue Service as follows:

> "One of the reasons why permission to report on a completed contract basis is given . . . is the fact that there are changes in the price of articles to be used, losses and increased costs due to strikes, weather, etc., penalties for delay and unexpected difficulties in laying foundations which make it impossible for any construction contractor, no matter how carefully he may estimate, to tell with any certainty whether he has derived a gain or sustained a loss until a particular contract is completed." Rev. Rul. 70-67, 1970-1 C.B. 117.

The present regulations dealing with long-term contract accounting were adopted in 1976. See T.D. 7397, January 16, 1976. These regulations were an outgrowth of a Treasury study of the tax accounting area that commenced in 1969 and was itself a response to the tax problems that arose in connection with the taxation of prepaid income. During the late 1950's and early 1960's, a series of cases dealing with the taxation of prepaid income attributable to the future performance of services reached the Supreme Court. See Schlude v. Comm., 372 U.S. 128 (1963); American Automobile Association v. U.S., 367 U.S. 687 (1961); and Automobile Club of Michigan v. Comm., 353 U.S. 180 (1957).

In each of these cases, the Court ruled that the accrual basis taxpayer involved therein was required to include the prepayments in gross income in the year of receipt. Each of these cases involved a taxpayer performing services, and thus, each taxpayer lacked any inventory and deducted all expenses associated with the particular business as they were incurred. Notwithstanding that these cases were limited to service taxpayers, there was great concern among manufacturers and contractors that the conclusion reached in these three decisions would be extended to manufacturers who received prepayments for goods in the course of production and to contractors who received progress payments during the course of construction. This concern was greatly heightened by the decision in Hagen Advertising Displays, Inc. v. Comm., 407 F.2d 1105 (6th Cir. 1969), where the Sixth Circuit held that the prepaid income doctrine was equally applicable to taxpayers engaged in the production and sale of goods.

In 1970, President Nixon's Task Force on Business Taxation recommended that there be closer conformity between tax and financial accounting. The Task Force was particularly disturbed by the disparity between tax and financial reporting of prepaid income. While prepaid income is not, and was not then, included in income for financial purposes until the prepayments are "earned" through the performance of services or the sale of goods, the accounting profession generally accelerates the reporting of both income and expense under long-term contracts as compared to the tax treatment afforded such contracts because of the accounting profession's preference for the use of the percentage of completion method. In response to the Task Force's concerns in this area, the Treasury embarked on a program to promote greater conformity between tax and financial reporting. The Treasury initiated such program with the publication of regulations to permit the deferral of prepaid income received by accrual basis manufacturers until such prepaid income is earned through the completion and delivery of the goods. Reg. § 1.451-5(b). However, as a condition to deferring such prepayments for tax purposes, taxpayers were required to defer such prepayments for financial reporting purposes. Reg. § 1.451-5(b)(1)(ii).

The resolution of the prepaid income problem for accrual basis manufacturers left open the problem of taxing progress payments received by taxpayers reporting income on a long-term contract basis. However, the Treasury initially believed that equity dictated that such taxpayers should also be permitted to defer the inclusion of progress payments in gross income for tax purposes provided that the progress payments were accorded conforming treatment for financial reporting purposes. Thus, proposed regulations were issued to provide that a taxpayer could use the completed contract method for tax purposes only if it used such method for financial reporting purposes. Prop. Reg. § 1.451-3(e)(1) (March 24, 1971).

The Treasury's proposal met with considerable opposition, not only from the construction and building industries, but also from numerous members of Congress. Letters and comments submitted by senators and congressmen indicated that Congress was uniformly opposed to the imposition of restrictions on the use of the completed contract method for tax purposes. The criticisms emanating from Congress were fairly unanimous in their assertion that a financial conformity requirement in this area was tantamount to an outright ban on the use of the completed contract method for tax purposes because the accounting profession generally required that the percentage of completion method be used for financial reporting of income from long-term contracts.

Congress recognized that there is a genuine difference between tax and financial reporting, reflected in disparate goals and differing attitudes towards the use of estimates to reflect revenue recognition.

In the final analysis, and after a considerable period of studying the problems, Treasury agreed to eliminate any financial reporting restrictions on the use of the completed contract method. Proposed regulations were issued in 1972 and final regulations were adopted in 1976 reflecting this position. T.D. 7397, January 16, 1976. In abandoning the financial conformity requirement and otherwise eliminating all proposed restrictions on the use of the completed contract method, the Treasury was convinced that the completed contract method clearly reflected the income of taxpayers with long-term contracts.

Although Treasury began its review of the completed contract method in the early 1970's with a view to making substantive modifications to the rules, the 1976 Treasury Decision adopting the final regulations did little more than to clarify certain ambiguities in the areas of eligibility and costing that had existed under the prior rules.

Under the prior long-term contract regulations, manufacturing contracts were not expressly included in the definition of long-term contracts. Reg. § 1.451-3(a) (1957). Nevertheless, certain manufacturers of large equipment had long been permitted to use the completed contract method of accounting as a result of favorable judicial precedents. *See e.g. Rice, Barton & Fales, Inc. v. Comm.*, 41 F.2d 339 (1st Cir. 1930); and *Grays Harbor Motorship Corp v. U.S.*, 45 F.2d 259 (Ct.Cl. 1930). However, the courts had prohibited taxpayers from using the special long-term contract methods for the sale of property for delivery more than one year after the signing of the contract (*Nona B. Wood v. Comm.*, 14 T.C.M. 1156 (1955), *aff'd this issue* 245 F.2d 888 (5th Cir. 1957)); for contracts for the sale of lumber (*C.H. Swift & Sons v. Comm.*, 13 B.T.A. 138 (1928)); for oil brokerage contracts requiring delivery more than one year in the future (*Lakeside Petroleum Co. v. U.S.*, 1 F.Supp. 31 (E.D. Ill. 1932)); and for contracts for the breeding of animals (*Est. of B.F. Whitaker v. Comm.*, 259 F.2d 379 (5th Cir. 1958)). The courts had apparently distinguished between general merchandising contracts and those calling for either building, installation or construction.

The 1976 regulations clarified which types of manufacturing contracts qualified for the special long-term contract methods. Manufacturing contracts only qualify if they involve the manufacture of: (1) unique items of a type which are not normally carried in the finished goods inventory of the taxpayer; or (2) items which normally require more than 12 calendar months to complete, regardless of the duration of the actual contract. Reg. § 1.451-3(b)(1).

The 1976 regulations specifically did not liberalize the eligibility rules to include architects, engineers and the like. The Internal Revenue Service had long excluded these taxpayers from using these special methods. See Rev. Rul. 70-67, 1970-1 C.B. 117.

With respect to the treatment of costs by taxpayers using the completed contract method of accounting, the 1976 regulations contained detailed rules where limited rules had previously been. Under the prior regulations, very few rules were provided to deal with the problems of costing under long-term contracts. See e.g. A.R.R. 8367, III-2 C.B. 57, declared obsolete by Rev. Rul. 67-123, 1967-1 C.B. 383; Edward Lane v. Comm., 37 T.C. 188 (1961). In general, these prior rules required the deferral of both direct and indirect costs attributable to the long-term contracts in progress.

The new regulations continued the same basic policy of deferring direct and indirect costs attributable to particular long-term contracts, but provided detailed rules for determining which costs (direct and indirect) are incident to and necessary for the performance of particular long-term contracts. Reg. § 1.451-3(d)(5). These rules are discussed in greater detail in section III herein. They basically conformed the allocation of costs under long-term contracts to other tax accounting areas and greatly clarified uncertainties existing under the prior rules.

The 1976 amendments to the regulations were designed to bring greater certainty in this area of tax accounting. The rules were not materially changed nor liberalized. This committee cannot accept the Treasury's effort at this time in light of the considerable effort just a few years ago to review this entire area of tax accounting.

III. THE COMPLETED CONTRACT METHOD IS CONSISTENT WITH TRADITIONAL TAX ACCOUNTING PRINCIPLES GOVERNING PROFIT AND LOSS RECOGNITION

A fundamental assumption underlying the Administration's proposals to repeal the completed contract and accrual methods of accounting for long-term contracts is that taxpayers using such methods obtain certain unintended benefits or an unfair advantage over other taxpayers reporting profit or loss under generally applicable methods of accounting. The committee contends that this assumption is incorrect and is due to the Treasury's failure to fully comprehend the historical relationship among the various methods of accounting. The committee maintains that when the tax accounting rules underlying the completed contract method are compared to the tax accounting principles that apply to taxpayers not performing long-term contracts, it is apparent that the methods are roughly comparable and do not confer unfair advantages on taxpayers performing long-term contracts.

Taxpayers engaged in the manufacture or construction of a product are ordinarily required to maintain inventories and to use the accrual method of accounting. See Reg. § 1.446-1(a)(4)(i); Reg. § 1.446-1(c)(2)(i); and Reg. § 1.471-1. Pursuant to these requirements, a taxpayer manufacturing or constructing a product would accumulate the costs incurred incident to and necessary for the manufacturing or construction activities until the related product is shipped, delivered, or accepted, depending on the taxpayer's regular method of accounting and would be offset against the contract price which would be includible in gross receipts at such time. See Reg. § 1.446-1(c)(1)(ii).

Pursuant to the accrual method of accounting, revenue is included in a taxpayer's gross income in the taxable year in which all events have occurred which fix the right to receive the revenue and the amount thereof can be determined with reasonable accuracy. See Reg. § 1.451-1(a); Spring City Foundry Co. V. Comm., 292 U.S. 182 (1934). As noted above, ordinarily, revenue is included in income when the manufacturer or contractor ships or delivers the product or such product is accepted by the purchaser, depending on the taxpayer's regular method of accounting in this regard. Under such general rule, the time when a particular taxpayer either bills the customer for the sale of the product or he actually receives payment for the product is irrelevant for accrual purposes.

In contrast to the foregoing general rule, a question arises as to the proper time for reporting income amounts received in advance of the shipment, delivery or acceptance of the product. Advance payments or progress payments are, by definition, amounts received by an accrual-basis taxpayers in advance of the time when such amounts would be properly accruable under the "all events test" noted above. Because it was generally perceived that such advance payments or progress payments had many characteristics of loans (Consolidated-Hammer Dry Plate & Film Co. v. Comm., 317 F.2d 829 (7th Cir. 1963)), it had always been assumed that the receipt of progress payments would be ignored for tax purposes and that these amounts should be included in income at the time they would ordinarily be included in income under the taxpayer's regular accrual method (i.e., at the time of shipment, delivery or acceptance). However, following a series of Supreme Court cases dealing with prepaid income received by taxpayers performing services, one court extended the prepaid income doctrine to the sale of goods and held that such prepayments were currently taxable. See Hagen Advertising Displays, Inc. v. Comm., 107 F.2d 1105 (6th Cir. 1969). Following this decision, the Treasury reconsidered the wisdom of taxing prepaid income which is nothing more than a form of financing. As a result, the Treasury issued regulations permitting prepaid income to be deferred pursuant to the taxpayer's regular method of accounting. See Reg. § 1.451-5.

With respect to the treatment of expenses by an accrual-basis taxpayer engaged in the manufacture or construction of a product, as noted above, the direct and indirect costs incurred incident to and necessary for the production of the product would be deferred until the product is shipped, delivered or accepted. Such deferred costs would be carried in an inventory account and could be valued at either cost or the lower of cost or market. See Reg. § 1.471-2(c). Thus, during the course of the production of the product, if it became apparent that the costs of production would exceed the contract price for the goods, the taxpayer would be entitled to deduct currently the amount of such ultimate loss, even prior to the actual completion and sale of the product. This would be true even if initial learning curves caused the cost of production of the first unit under a contract to be significantly higher than the costs of producing subsequent units in a multi-unit contract. See Reg. § 1.471-4; Space Controls, Inc. v. Comm., 322 F.2d 144 (5th Cir. 1963); E.W. Bliss Co. v. U.S., 351 F.2d 449 (6th Cir. 1965). Alternatively, a taxpayer could elect to use an equally liberal method of inventory valuation -- the LIFO method. See IRC § 472. Pursuant to such method, the taxpayer could eliminate from its inventory and deduct currently the inflation in the cost of such product.

Finally, with respect to the determination of the inventory cost of such product, a taxpayer manufacturing or constructing a product would be required to use the full absorption method of inventory costing. Under such method, all direct production costs and certain indirect production costs must be includible in inventoriable costs for tax purposes. _See_ Reg. § 1.471-11(c)(2)(i). In contrast, certain indirect costs are permitted to be expensed as period costs for tax purposes. _See_ Reg. § 1.471-11(c)(2)(ii). A third category of indirect production costs, which contains most of the large overhead costs (_i.e._, property taxes, depreciation, fringe benefits, and factory administrative costs), are includible in or excludible from inventory for tax purposes depending on their treatment in the taxpayer's financial statements. _See_ Reg. § 1.471-11(c)(2)(iii). This three-category approach is quite flexible and enables most accrual-method taxpayers to deduct as a period cost a significant portion of their regular operating expenses. Where an accrual-basis taxpayer uses completely different overall methods of accounting for tax and financial reporting purposes, the third category noted above is eliminated in the regulations, with some of the costs assigned to inventory and the balance assigned to period costs. _See_ Reg. § 1.471-11(c)(3). This treatment is virtually identical to that accorded to taxpayers employing the completed contract method.

For taxpayers manufacturing or constructing a product under a long-term contract, the completed contract method of accounting provides the same basic framework of revenue recognition and cost accumulation as is found under the traditional accrual method. Under the completed contract method, contract revenue is included in income in the taxable year in which the contract is completed and accepted, which is comparable to the time of revenue recognition under the accrual method (i.e., the date of shipment, delivery or acceptance of a product). Progress payments under the completed contract method are also ignored to the same extent as under the accrual method.

With respect to the treatment of expenses, contract costs under the completed contract method are accumulated and allowed as an offsetting deduction when contract revenues are taken into income upon the completion of the contract. Reg. § 1.451-3(d). In applying such rule, certain indirect costs are permitted to be deducted currently. These rules directly parallel the treatment afforded an accrual-basis taxpayer

However, the costing rules applicable to taxpayers using the completed contract method are disadvantageous in one significant respect. The Internal Revenue Service takes the position that the accumulated contract costs under the completed contract method are not inventoriable costs. *See* Rev. Rul. 59-329, 1959-2 C.B. 138. Accordingly, under the Service's view, these costs are not eligible for either the lower of cost or market method nor for the special LIFO ordering rules.

The Administration alleges that the completed contract method contains a significant loophole, i.e., the ability of taxpayers to deduct currently certain indirect costs, while deferring all contract revenues until completion of the contract. However, as noted above, all accrual-method taxpayers may deduct certain indirect costs even if such costs are related to the manufacture or construction of a product that remains in inventory. Moreover, when one compares the range of costs which are currently deductible under the completed contract method with those period costs deductible under the full absorption inventory rules applicable to manufacturers, it is quite apparent that the latter group of taxpayers have greater flexibility than taxpayers using the completed contract method. For example, all of the indirect costs that must be inventoried for tax purposes on the one hand, and all of the indirect costs that may be excluded from inventory for tax purposes on the other hand, are identical to the costs that must be deferred or are deductible under the completed contract method. Compare Reg. § 1.471-11(c)(2)(i)and (ii) with Reg. § 1.451-3(d)(ii) and (iii). In contrast, while the balance of the indirect costs may either be inventoried or not at the option of the accrual-basis taxpayer based on his financial statement treatment of such costs, all of such costs except fringe benefit costs and the cost of strikes, etc. must be deferred under the completed contract method. Accordingly, contrary to the Administration's assertions, taxpayers not using the completed contract method may be, and in fact are, generally expensing a greater proportion of operating expenses than taxpayers using the completed contract method. When this fact is combined with the unavailability of the lower of cost or market method and LIFO method for taxpayers using the completed contract method, it is difficult to perceive that the Administration views such method as abusive when compared to the traditional accrual method available to all taxpayers, including those having long-term contracts and those without such business.

IV. EVALUATION OF ADMINISTRATION PROPOSALS

A. Alleged Abuses

In view of the consistency of the existing long-term contract rules with the more general tax accounting policies regarding revenue recognition and costs and in view of their 60 year history, the question which must be addressed is why this Administration is now proposing such a drastic revision of the present rules. Let us focus on the reasons which the Administration offers as support for its proposals.

First, the Administration alleges that some companies have utilized either change orders to contracts or supplemental maintenance agreements as a means of indefinitely extending a long-term contract, so that 10 or 20 years elapse before any income is reported. Second, the Administration asserts that in some cases the allowance of certain period costs on current contracts exceeds revenues reported on older completed contracts, thereby creating artificial losses. The Administration claims that these aberrations occur under the accrual method, as well as under the completed contract method. Finally, the Administration notes that in at least one case a company has used the foregoing tax accounting rules to eliminate earnings and profits and pay out "tax-free" dividends to shareholders. In summary, the alleged evils are indefinite deferral of contract completions, excessive deduction of certain period costs, and the payment of "tax-free" dividends.

In each of the foregoing instances, the committee submits that the present regulations already provide ample legal authority to challenge the foregoing practices where they appear to be abusive.

1. Deferral of Contract Completions

With respect to the problem of open-ended completion dates, the current regulations contain a number of provisions designed to combat abuses in this area. The current long-term contract regulations provide that under the completed contract method, the contract price is not includible in a contractor's gross income until the contract is finally completed and accepted (Reg. § 1.451-3(b)(2)). The regulations, however, also state that, "a taxpayer may not delay the completion of a contract for the principal purpose of deferring Federal income tax." Reg. § 1.451-3(b)(2). This provision enables the Internal Revenue Service to treat a contract as completed where relatively minor amounts of work under the contract are purposefully delayed in order to prevent contract closing.

A second provision available to the Internal Revenue Service to combat the problem of indefinite deferral is covered under the "dispute" rules. Prior to the adoption of the current long-term contract regulations, the existence of any dispute between a long-term contract taxpayer and customer, regardless of how minor, held the contract open indefinitely. Irwin v. Comm., 238 F.2d 874 (3rd Cir. 1956); C. H. Leavell v. Comm., 53 T.C. 426 (1969). Under the current regulations, the rules have been changed so that if the dispute is sufficiently minor that the taxpayer is assured of a profit or a loss on the contract regardless of the outcome of the dispute, such assured amount of profit or loss is accrued currently. Reg. § 1.451-3(c)(2). Thus, these rules render it unlikely that a taxpayer will be able to achieve indefinite deferral on long-term contracts where such taxpayer undertakes to delay the final completion and acceptance of a contract by interposing a dispute.

As a further measure to deal with unintended deferral, the regulations contain special rules for determining when a single contract calling for construction of separable units may be severed into separate long-term contracts or when a series of contracts which cover construction of what is basically a single unit of property should be aggregated into a single long-term contract. Reg. § 1.451-3(e). These provisions represent a codification of long-standing judicial decisions. See, e.g., Grays Harbor Motor Ship Corp. v. U.S., 45 F.2d 259 (Ct. Cl. 1930) (a single contract calling for the construction of seven ship holds was considered severable, with each hold being considered a separate project reportable on the completed contract basis); Helvering v. National Contracting Co., 69 F.2d 252 (8th Cir. 1934) (eight individual contracts covering the construction of two schools were held to constitute a single contract, reportable on a completed contract basis).

In conclusion, under both the regulatory rules and judicial precedents in this area, the Internal Revenue Service has ample authority to prevent the unjustified deferral of income with respect to contracts that are held open indefinitely, whether through operations and maintenance agreements, or any other agreements which are, in substance, separate contracts. Notwithstanding the adequacy of the existing rules to deal with this deferral problem, the Service apparently has experienced enforcement shortcomings. For this, the Internal Revenue Service has itself to blame. In the six years that the current long-term contract regulations have been outstanding, and in the entire 60 year period that the completed contract method has been permitted, not a single revenue ruling has ever been published to detail the situations in which severing or aggregating of contracts would be required. Our committee submits that the Administration should redirect its attention away from repeal of the completed contract method and towards better enforcement of the existing rules.

2. Period Costs

The second principal type of abuse which the Administration contends is allowed by the existing long-term contract rules is the deductibility of excessive period costs. The Administration claims that such excessive deductions occur under both the completed contract method and the accrual shipments method.

As noted in the preceding section, the costing rules that apply under the completed contract and accrual methods are totally consistent. Moreover, if either set of rules is more advantageous to the taxpayer, it is clearly not the long-term contract rules. Accordingly, if there are excessive deductions in this area, such deductions are allowed not by the completed contract method but by long-standing tax accounting principles which apply to all accrual taxpayers. It is inconceivable that Treasury can ask this Congress to change these long-standing rules without affirmatively changing the rules for all taxpayers, including both taxpayers with long-term contracts and those without. Such rules should not be disturbed lightly and certainly not in the name of correcting abuses.

The committee recognizes that under the current framework of determining which costs must be deferred and which are deductible, there may be particular individual cases of abuse under the current rules. Admittedly, there are several categories of cost in the long-term contract regulations that are nebulously defined. In practice, some taxpayers have undoubtedly taken the benefit of the doubt and claimed a greater proportion of their expenditures as period costs than they may be entitled to under a proper reading of the regulations. To combat such practices, the Administration does not need to require the capitalization of general overhead expenses that all other types of taxpayers are entitled to expense. Instead, the Internal Revenue Service should publish additional guidelines under the existing regulations which clarify the division between allocable contract costs and deductible period costs. Armed with such guidelines, Internal Revenue Service agents would be able to enforce the current regulations. In our committee's view, such a balanced approach would eliminate any existing abuses and obviate the need for more drastic and unfair statutory and regulatory changes.

3. "Tax-Free" Dividends

The third area of abuse addressed by the Administration's proposals is the distribution of "tax-free" dividends by certain corporations using the completed contract method. Such distributions are presumably not taxable because the distributing corporations utilizing such approach have not recognized any income under their completed contract method of accounting, and, as a result, have no earnings and profits from which to distribute "dividends." Shareholders of such corporations would receive tax-free distributions from the corporation to the extent of the basis they have in such corporation's stock.

If the Internal Revenue Service perceives such tax-free distributions to be an abuse of the completed contract method, and probably rightly so, it can prevent the "tax-free" distribution result by requiring the corporations to determine their earnings and profits on the basis of the percentage of completion method.

B. Evaluation of Administration's Proposal

Instead of concentrating its efforts on eliminating the abuses addressed in the Administration's explanation of its tax proposals, the Administration has adopted a far more drastic approach -- the repeal of the completed contract method, the accrual method, and the cash method of accounting for long-term contracts. In place of these methods, the Administration would require the use of either the percentage of completion method or a new method, the progress payment method, and would treat certain period costs as tax preference items in the new proposed minimum tax on corporations.

In the case of the percentage of completion method, everyone should be well aware of its shortcomings. From a conceptual viewpoint, the essential weakness of the percentage of completion method is that it taxes gains or losses before they are "realized" in the traditional sense of the term. While there is no specific statutory rule for determining when an item of income is "realized," the long-standing judicial precedents in this area start with the notion that "realization" requires the receipt or the fixing of a right to receive something of value. See Eisner v. Macomber, 252 U.S. 189 (1920); Burnet v. Sanford and Brooks Co., 282 U.S. 359 (1931); Continental Tie and Lumber Co. v. U.S., 286 U.S. 290 (1932).

In contrast, under the percentage of completion method, it is irrelevant whether anything of value is received. Instead, the measurement of income under the percentage of completion method is based exclusively on the percentage of the long-term contract that is deemed completed each year. Thus, even where an estimate of progress towards completion may be accurately made, the method resorts to a legal and economic fiction in measuring income, i.e., that a taxpayer who has performed one-quarter of the work under a long-term contract has "earned" and, therefore, "realized" one-quarter of the total estimated profit on the contract. The committee is not aware of any other method of accounting under the Internal Revenue Code where taxation is based on such a principle of estimation.

Furthermore, if the percentage of completion method results in the premature taxation of income prior to its realization in cases where progress towards completion is accurately measured, where does this leave the method in cases where progress towards completion is not reasonably ascertainable? As was noted in Rev. Rul. 70-67, supra, the reason that special methods of accounting are permitted to be used for long-term contracts is that the outcome of such contracts is inherently unpredictable. Given that background, it seems inconceivable that the percentage of completion method should be a preferred method of tax accounting as compared to financial accounting.

Even the Administration recognizes the shortcomings of the percentage of completion method. For example, in an analogous context, the Internal Revenue Service recently argued that the taxpayer in Rockwell International Corp. v. Comm., 77 T.C. No. 57 (Oct. 13, 1981), could not deduct estimated losses under the lower of cost or market inventory method. The taxpayer was an aerospace contractor that sought to write down its work-in-progress to reflect an "unrealized" loss based upon its estimate of the future unprofitability of the contract. The Court concluded:

> "Putting this aside, however, we are satisfied that the uncertainties surrounding petitioner's loss estimate were far too great on September 30, 1969, to permit recognition of any portion of the loss (by way of an inventory writedown or otherwise) for that fiscal year. . . Given the number of years remaining on the contract, the

> fact that it was only half completed, the fact that actual costs and revenues significantly exceeded the taxpayer's estimates, and the magnitude of the uncertainties which prevailed on the inventory date regarding both contract costs and revenue, we think that the relatively small spread between the actual and projected outcomes (relative, that is, to total contract costs) can only be viewed as the product of a coincidence, and any comparison between the two is superficial and misleading. We hold, therefore, that petitioner has failed to establish by sufficient objective evidence that its P.O. 181 ending inventory had a value which was less than its cost on September 30, 1969. Accordingly, no inventory writedown is permissible under the terms of section 1.471-4(b), Income Tax Regs."

If estimates of future losses were too speculative to support a market writedown under the inventory provisions in that case, how could the precise same type of estimates be used to measure profit or loss under the percentage of completion method? The percentage of completion method taxes income before it is realized and it measures such income on the basis of estimates that would be considered too unreliable for use under any other provisions in the Internal Revenue Code.

In recognition of the shortcomings of the percentage of completion method, the Administration has proposed an entirely new method of accounting for long-term contracts -- the progress payment method. Under this method, progress payments actually received and payments due and payable would be currently taxable. In addition, certain borrowings against a long-term contract would be treated as progress payments. In contrast, costs of performing a long-term contract would only be deductible against, and to the extent of, progress billings.

The progress payment method is a not-so-subtle attempt to tax a taxpayer's gross receipts. The concept of income realization, which is at least estimated under the percentage of completion method, is totally lost under this new method. Where has the history of our income tax laws gone if taxpayers are forced to pay tax on gross receipts rather than income? From the very outset, the Supreme Court has rejected the contention that income is equivalent to gross receipts. Income is only the excess, if any, of the sale price over the cost. In the case of Doyle v. Mitchell Bros. Co., 247 U.S. 179, 184, the Court long ago rejected the position that income equalled the gross receipts received by a taxpayer, saying:

> "Yet it is plain, we think, that by the true intent and meaning of the act the entire proceeds of a mere conversion of capital assets were not to be treated as income. Whatever difficulty there may be about a precise and scientific definition of 'income,' it imports, as used here, something entirely distinct from principal or capital either as a subject of taxation or as a measure of the tax; conveying rather the idea of gain or increase arising from corporate activities. As was said in Stratton's Independence v. Howbert . . . 'Income may be defined as the gain derived from capital, from labor, or from both combined.'
>
> Understanding the term in this natural and obvious sense, it cannot be said that a conversion of capital assets invariably produces income. If sold at less than cost, it produces rather loss or outgo. Nevertheless, in many if not in most cases there results a gain that properly

> may be accounted as a part of the 'gross income' received 'from all sources'; and by applying to this the authorized deductions we arrive at 'net income.' In order to determine whether there has been gain or loss, and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration."

The progress payment method is not only antithetical to the history of our tax laws, but it is also highly discriminatory in its effect on taxpayers with long-term contracts. While all other accrual basis taxpayers may continue to defer the taxation of progress payments for work to be completed and delivered in a future taxable year (Reg. § 1.451-5), taxpayers with long-term contracts would pay tax currently on such payments under the progress payment method. In contrast, while cash basis taxpayers must include progress payments in gross income when received, all costs of performing the work would continue to be deductible when paid, regardless of whether such costs exceed the amount of income received. Reg. § 1.461-1(a)(1). Thus, the progress payment method would force a taxpayer with long-term contracts to pay considerably more taxes than either an accrual-basis or cash-basis taxpayer who does not have long-term contracts.

Finally, in its proposals for a new minimum tax on corporations, the Administration would add to its list of tax preferences certain period costs incurred on long-term contracts entered into on or before February 26, 1982.

The committee believes that it is totally unfair to consider as a tax preference item period costs under a long-term contract that are identical to costs that may be expensed by any other type of business. As noted in the preceding section, this category of costs is virtually identical to the list of costs which may be expensed by manufacturers, wholesalers and retailers, and service businesses. If these costs are not a tax preference for such other businesses, they should not be a tax preference for taxpayers with long-term contracts.

V. Conclusion

The Administration's proposed changes in the tax accounting treatment of taxpayers having long-term contracts is totally unwarranted. For sixty years, the completed contract method of accounting has been widely accepted as clearly reflecting the income of taxpayers doing business under long-term contracts. Furthermore, there is strong indication in many earlier court decisions that such method is perhaps the best practical method for reporting the income of such taxpayers. In addition, wholly apart from any issues which exist with respect to the completed contract method, no changes should be made in the availability of the traditional accrual method of accounting for long-term contracts.

Perhaps even more important than the historical perspective of these rules is the fact that the tax laws should be applied evenhandedly. To change the rules for taxpayers doing business under long-term contracts in the manner proposed by the Administration would subject these taxpayers to rules which are much more stringent than those which would apply to all other business taxpayers using the cash, accrual or some hybrid method of accounting. Such discrimination has never been a part of our tax law without explicit recognition that such discrimination is warranted.

Finally, if there are problems with respect to the taxation of long-term contracts, these problems can be adequately dealt with under the regulations as they now exist. Rather than seek some ill-conceived Congressional solution to their perceived problems, the Treasury should direct the Internal Revenue Service to deal with the problems at the audit level.

Respectfully submitted,

The Committee to Preserve the
Completed Contract Method

STATEMENT OF ROBERT A. BEST, EXECUTIVE VICE PRESIDENT, AMERICAN LEAGUE FOR EXPORTS AND SECURITY ASSISTANCE, WASHINGTON, D.C.

Senator CHAFEE. OK. Mr. Best.

Mr. BEST. Thank you, Mr. Chairman. I will be as brief as possible. I appreciate this opportunity to appear again before many old friends and former colleagues.

The CHAIRMAN. As Senator Chafee may recall, Mr. Best was a member of the staff of this committee. And he has done outstanding work here in the past.

Mr. BEST. Thank you, Mr. Chairman. I appear before you today on behalf of the American League for Exports and Security Assistance, a labor-management organization committed to a positive job creating national export policy, and a strong industrial base capable of serving well the economic, foreign policy, and security goals of the Nation. The membership of the organization is attached to this statement.

The underlying issue of these hearings—to consider measures to reduce the projected triple digit deficits—is of paramount importance to the economic and indeed security interests of our Nation, and, I would add to many of our friends and allies abroad whose economies are so interwoven with our own.

We cannot exercise a strong leadership position in the world with a sick economy. A bipartisan plan to reduce these projected deficits is urgently needed. And, if the committee wishes, I would be prepared to give some personal thoughts on this at the end of the testimony.

The immediate issue that concerns us is the administration's proposed disallowance of a long established method of accounting involving long-term Government contracts.

Senator CHAFEE. Mr. Best, we are not going to have time for you to read this whole statement.

Mr. BEST. I will not read this whole statement. We believe that the proposed changes would not serve well our Nation's economic or security interests. The irony of this proposal is that, if enacted, it is likely to increase defense expenditures without any significant increase in revenues at a time when the budget deficits are the principal cause of concern. Procurement costs will rise as defense contractors pass on additional costs to the Government. Any short-term revenue gains to the Treasury would be significantly limited by the effect of the transition rules.

In the longer term, there would be a return to the prolonged period of litigation which prevailed for many years prior to the adoption of the 1971 regulations. If Congress passes this proposal, I strongly suspect you will be considering its repeal next year.

Mr. Chairman, I don't believe I need to read the rest of my statement. I would just like to summarize it.

The rate of return in the aerospace industry is not high. For the past 20 years it has averaged about 3 percent. As a matter of fact, the defense portion of their business has a lower rate of return than the commercial portion. In addition, the industry pays over 40 percent of its income to the Federal Government in taxes.

On the percentage of completion method which has been proposed, I will just mention that Adm. Hyman Rickover, who has not been particularly a staunch defender of defense contractors, vigorously criticized this method in public testimony before House committees. Also in a GAO letter of October 8, 1975, the then head of the GAO, Elmer Staats, said, "The principal advantage of the completed contract method is that it is based on the results as finally determined rather than on estimates for unperformed work."

Mr. Chairman, to the extent that refinements and indeed to the extent that the elimination of abuses are deemed necessary, I think that the wiser procedure would be through a joint taxpayer-Government effort, with the full participation of your staff, in a Treasury regulation process, rather than through a legislative route, which, on such a complex issue, could end up creating more problems than solutions.

That completes my testimony. I'd be delighted to answer any questions you may have.

[The prepared statement follows:]

Statement of Robert A. Best

Mr. Chairman, and other distinguished members of the Committee on Finance.

I appear before you today on behalf of the American League for Exports and Security Assistance, Inc., a labor-management organization committed to a positive, job creating national export policy, and a strong industrial base capable of serving well the economic, foreign policy and security goals of the nation. The membership of the organization is attached to this statement.

The underlying issue of these hearings -- to consider measures to reduce the projected triple digit deficits -- is of paramount importance to the economic and indeed security interests of our nation and, in a shrinking interdependent world, those same interests of our friends and allies. We cannot have a strong leadership role in the world with a sick economy. A bipartisan plan to reduce the projected deficits is urgently needed. If the Committee wishes I can give a few personal thoughts on this at the end of the testimony

The immediate issue that concerns us is the Administration's proposed disallowance of a long established method of accounting involving long term government contracts. We believe that the proposed changes would not serve well our nation's economic or even security interests.

THE IRONY OF THIS PROPOSAL IS THAT, IF ENACTED, IT IS LIKELY TO INCREASE DEFENSE EXPENDITURES WITHOUT ANY SIGNIFICANT INCREASES IN REVENUES AT A TIME WHEN THE TRIPLE DIGIT PROJECTED BUDGET DEFICITS ARE THE PRINCIPAL CAUSE OF GRAVE CONCERN IN THE COUNTRY. PROCUREMENT COSTS WILL RISE AS DEFENSE CONTRACTORS PASS ON ADDITIONAL COSTS TO THE GOVERNMENT. ANY SHORT TERM REVENUE GAIN TO THE TREASURY WOULD BE SIGNIFICANTLY LIMITED BY THE EFFECT OF THE TRANSITION RULES. IN THE LONGER TERM THERE WOULD BE A RETURN TO THE PROLONGED PERIOD OF LITIGATION WHICH PREVAILED FOR MANY YEARS PRIOR TO THE ADOPTION OF THE 1971 REGULATIONS. IF CONGRESS PASSES THIS PROPOSAL, I STRONGLY SUSPECT YOU WILL BE CONSIDERING ITS REPEAL NEXT YEAR.

AS JOHN NOLAN, A FORMER DISTINGUISHED ASSISTANT SECRETARY OF TREASURY HAS INDICATED TO THIS COMMITTEE, THE COMPLETED CONTRACT METHOD OF ACCOUNTING HAS A LONG HISTORY. FIRST PROMULGATED IN 1918 FOR USE IN CONSTRUCTION CONTRACTS, THE COMPLETED CONTRACT METHOD WAS EXTENDED IN 1971 TO MANUFACTURING BUSINESSES WITH LENGTHY CONTRACTS, AFTER EXTENSIVE STUDY BY THE TREASURY DEPARTMENT, THE INTERNAL REVENUE SERVICE, IN CONSULTATION WITH THE JOINT COMMITTEE ON TAXATION. THE PURPOSE OF THIS CONFORMING REGULATION WAS TO RESOLVE LITIGATION AND UNCERTAINTIES SURROUNDING LONG TERM CONTRACTS WHILE PROTECTING THE INTERESTS OF GOVERNMENT AND INDUSTRY.

THERE ARE MAJOR UNCERTAINTIES IN DETERMINING PROFITS OR LOSSES ON LONG-TERM CONTRACTS. THE CAUSES OF THESE UNCERTAINTIES INCLUDE THE PERIOD OF PERFORMANCE, TECHNOLOGICAL UNCERTAINTY AND THE VIRTUAL IMPOSSIBILITY OF ESTIMATING COST, OR PRICE, WITH ANY DEGREE OF CERTAINTY.

BECAUSE MANY GOVERNMENT CONTRACTORS ARE REQUIRED TO PUSH THE STATE OF THE ART IN ORDER TO MEET THEIR CONTRACTUAL OBLIGATIONS, THE ABSENCE OF RELEVANT HISTORICAL COST DATA MAKES RELIABLE COST ESTIMATING VIRTUALLY IMPOSSIBLE. THIS IN TURN, IS ONE OF THE CAUSES OF AN UNSATISFACTORILY LOW, ONLY 3 PER CENT, AVERAGE RETURN ON SALES IN THE AEROSPACE INDUSTRY OVER THE PAST 20 YEARS COMPARED TO OVER 5 PER CENT FOR ALL MANUFACTURING. AND THE INDUSTRY HAS PAID OVER 40 PER CENT OF ITS TOTAL INCOME TO THE FEDERAL GOVERNMENT IN INCOME TAXES. TABLES SUPPORTING THESE FACTS ARE IN THE APPENDIX.

THE DIFFICULTIES AND INACCURACIES INHERENT IN ESTIMATING THE ULTIMATE PROFIT OR LOSS ON LONG-TERM GOVERNMENT CONTRACTS HAVE INFLUENCED THE SECURITIES AND EXCHANGE COMMISSION TO CONSIDER THEIR POTENTIALLY SIGNIFICANT IMPACT UPON THE INVESTMENT CHARACTERISTICS OF AEROSPACE INDUSTRY SECURITIES. CONSEQUENTLY, THE SEC RECOGNIZED THE RISK AND UNCERTAINTY IN LONG-TERM ACTIVITIES AND REQUIRED DISCLOSURE REPORTS BY LONG-TERM CONTRACTORS TO BE "MORE COMPREHENSIVE" THAN THE USUAL MANUFACTURING FIRM DISCLOSURES IN ORDER TO ENABLE INVESTOPS TO APPRAISE SUCH RISKS AND UNCERTAINTIES.

Prior to the adoption of the completed contract regulations, contractors employed various tax accounting methods which required the use of estimates. As might have been anticipated, this created many inconsistencies and distortions between taxpayers and between tax years. Tax controversies developed which required resolution in the courts. The final adoption of the completed contract regulations in 1976 established a uniform tax accounting method for all contractors which assures that income taxes are levied and payable at the time that all costs and revenues are certain, fixed and determinable, i.e., when the contract is complete.

The two alternative accounting systems advanced by the Administration deserve some comment. Adoption of either of the proposed methods would represent a giant step backward in tax administration. Both involve the taxation of hypothetical income. In the case of the estimate-based percentage of completion method, all the old subjective judgement controversies which historically plagued taxpayers, government, and the courts will be resurrected. The percentage of completion method has been labeled by various Congressional Committees as an inadequate device for income determination in the case of long-term defense contracts (House Report 95-270, dated May 9, 1977; Senate Committee on Government Operations study entitled "The Accounting Establishment", December 1976). Admiral Hyman Rickover, not a particular defender of defense contractors, vigorously criticized the percentage of completion method of accounting in public testimony.

SOME FORM OF THE PERCENTAGE OF COMPLETION METHOD IS ADMITTEDLY USED FOR FINANCIAL ACCOUNTING BY THOSE TAXPAYERS WHO CURRENTLY USE THE COMPLETED CONTRACT METHOD FOR TAX PURPOSES. THE COMPATIBILITY OF THIS DUAL ACCOUNTING WAS ADDRESSED BY THE SUPREME COURT IN THE THOR CASE IN WHICH THE COURT RECOGNIZED THAT DIFFERENCES BETWEEN FINANCIAL STATEMENTS REPORTED TO SHAREHOLDERS AND TAXABLE INCOME REPORTED TO THE GOVERNMENT ARE NECESSARY IN ORDER TO TAX INCOME ONLY WHEN IT IS CERTAIN, FIXED AND DETERMINED. THE COMPLETED CONTRACT METHOD RECOGNIZES THIS PRINCIPLE. A GAO LETTER OF OCTOBER 8, 1975 TO THE OVERSIGHT SUBCOMMITTEE OF THE HOUSE BANKING, FINANCE AND URBAN AFFAIRS COMMITTEE STATES: "THE PRINCIPAL ADVANTAGE OF THE COMPLETED CONTRACT METHOD IS THAT IT IS BASED ON THE RESULTS AS FINALLY DETERMINED, RATHER THAN ESTIMATES FOR UNPERFORMED WORK."

THE "PROGRESS PAYMENTS" METHOD, AN INVENTION OF THE TREASURY, IS SO POORLY DEFINED THAT COMMENTS ON ITS MERITS ARE DIFFICULT. HOWEVER, IT APPEARS TO REPRESENT NOTHING MORE THAN AN ILL-ADVISED ATTEMPT TO TAX CASH FLOW RATHER THAN INCOME. THE INVENTION OF THIS METHOD WOULD SEEM TO BE A TACIT ADMISSION ON THE PART OF THE ADMINISTRATION OF THE IMPRACTICALITY OF ACCURATE INTERIM ESTIMATES OF INCOME IN LONG-TERM CONTRACTS. PARTICULARLY ONEROUS IS THE PROVISION THAT ALL POSITIVE CASH FLOW IS IMMEDIATELY TAXED WHILE TAX RELIEF ASSOCIATED WITH NEGATIVE CASH FLOW IS DEFERRED UNTIL THE TAXPAYER CAN DEMONSTRATE THAT SUCH NEGATIVE CASH FLOW EXCEEDS ANY PROSPECT OF ULTIMATE RECOVERY -- A NEAR

IMPOSSIBILITY IN ALL BUT THE LATE STAGES OF COMPLEX LONG-TERM CONTRACTS.

A STATED GOAL OF THE REAGAN ADMINISTRATION'S PROPOSAL TO ELIMINATE THE COMPLETED CONTRACT METHOD IS THE ERADICATION OF ALLEGED ABUSES. THIS "DESTROY THE TAX SYSTEM IN ORDER TO SAVE IT" APPROACH TO THE PERCEIVED PROBLEM IS TOTALLY UNWARRANTED. THE CONCEPTUAL VALIDITY OF THE COMPLETED CONTRACT METHOD HAS BEEN PROVEN OVER THE YEARS. TO THE EXTENT THAT REFINEMENTS IN THE APPLICATION OF THE METHOD ARE DEEMED NECESSARY, SUCH ACTION SHOULD BE ACCOMPLISHED IN THE CONTEXT OF A JOINT TAXPAYER AND GOVERNMENT EFFORT USING A TREASURY REGULATION PROJECT AS THE VEHICLE.

THE ELIMINATION OF THE COMPLETED CONTRACT METHOD WOULD INEVITABLY RESULT IN A RE-EVALUATION OF THE CURRENT CAPITAL INVESTMENT PLANS OF INDUSTRY. PRESENT RETURNS ON INVESTMENT IN THE DEFENSE BUSINESS ARE, AT BEST, MARGINAL. THEREFORE, THE ELIMINATION OF THE COMPLETED CONTRACT METHOD COULD DICTATE THAT FUTURE CAPITAL INVESTMENT COMMITMENTS BE DIRECTED TOWARD OTHER AND MORE PROFITABLE PRODUCT LINES OF BUSINESS.

THE FINANCING OF FOREIGN AND DOMESTIC CONTRACTS THROUGH ADVANCE OR PROGRESS PAYMENTS SHOULD NOT BE INTERFERED WITH BY IMPOSITION OF TAX ON THE CASH ADVANCE AT THE TIME OF RECEIPT. THE PURPOSE OF THESE PAYMENTS IS TO PROVIDE THE CASH REQUIRED

BY THE CONTRACTOR TO PAY FOR MATERIAL, LABOR AND OTHER COSTS. THERE IS NO LOGICAL RATIONALE WHICH WOULD SUPPORT THE TAXATION OF WHAT IS ESSENTIALLY BORROWING. SUCH A PROPOSAL FLIES IN THE FACE OF THE CONSIDERED JUDGEMENT OF TREASURY AS EXPRESSED IN THE ADVANCE PAYMENT REGULATIONS PROMULGATED IN 1976.

IN SUMMARY, WE BELIEVE THAT (1) THE LONG-TERM AND HIGH TECHNOLOGY CHARACTERISTICS OF LONG-TERM CONTRACTS MAKE COST AND REVENUE PROJECTIONS UNRELIABLE; (2) THE COMPLETED CONTRACT TAX ACCOUNTING METHOD IS AN APPROPRIATE AND EFFECTIVE MEANS TO ALLEVIATE THE PROBLEM OF PREMATURE TAXATION WHICH WOULD OTHERWISE BE INHERENT IN SUCH PROJECTIONS; (3) IT IS CONSISTENT WITH IRS POLICY OF RECOGNIZING THE TAXABLE NATURE OF REVENUE AND EXPENSE ITEMS AT THE TIME THEY BECOME FIXED AND DETERMINABLE; (4) EXISTING TREASURY REGULATIONS ARE ADEQUATE TO DEAL WITH ABUSES; AND FINALLY, THAT DESPITE THE NATIONAL IMPORTANCE OF THE U. S. DEFENSE INDUSTRY, IT IS CHARACTERIZED BY A LEVEL OF PROFITABILITY WHICH IS ALREADY SO CRITICALLY INADEQUATE THAT THE COMMITMENT OF ADDITIONAL CAPITAL INVESTMENT COULD VERY WELL BE JEOPARDIZED AT A TIME WHEN THE GOVERNMENT IS COMMITTED TO REVITALIZE OUR DEFENSE POSTURE AND SECURITY.

American League for Exports and
Security Assistance, Inc.

ARMISTEAD I. SELDEN
PRESIDENT AND GENERAL MANAGER
ROBERT A. BEST
EXECUTIVE VICE PRESIDENT
HERBERT Y. SCHANDLER
VICE PRESIDENT
WILLIAM H. HULSE
CHAIRMAN
JAMES B. BOOE
VICE CHAIRMAN

475 L'ENFANT PLAZA, S.W.
SUITE 4400
WASHINGTON, D.C. 20024
PHONE
(202) 554-1107
(202) 554-1108

ALESA MEMBERSHIP

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UNIONS

Communications Workers of America, AFL-CIO
International Brotherhood of Teamsters, Chauffeurs, Warehousemen and Helpers
Marine Engineers' Beneficial Association, AFL-CIO
United Brotherhood of Carpenters and Joiners of America, AFL-CIO

NET PROFIT AFTER TAXES
AS A PERCENT OF SALES
FOR MANUFACTURING CORPORATIONS
Calendar Years 1960-1980

Year	All Manufacturing Corporations	Non-Durable Goods	Durable Goods	Aerospace[a]
1960	4.4%	4.8%	4.0%	1.4%
1961	4.3	4.7	3.9	1.8
1962	4.5	4.7	4.4	2.4
1963	4.7	4.9	4.5	2.3
1964	5.2	5.4	5.1	2.6
1965	5.6	5.5	5.7	3.2
1966	5.6	5.5	5.6	3.0
1967	5.0	5.3	4.9	2.7
1968	5.1	5.3	4.9	3.2
1969	4.8	5.0	4.6	3.0
1970	4.0	4.5	3.6	2.0
1971	4.1	4.5	3.8	1.8
1972	4.4	4.6	4.3	2.4
1973	4.7	5.0	4.5	2.9
1974	5.5	6.4	4.7	2.9
1975	4.6	5.1	4.1	2.9
1976	5.4	5.5	5.2	3.4
1977	5.3	5.3	5.3	4.2
1978	5.4	5.4	5.5	4.4
1979	5.7	6.1	5.2	5.0[r]
1980	4.9	5.6	4.0	4.2

Source: Federal Trade Commission, "Quarterly Financial Report for Manufacturing, Mining and Trade Corporations."

[a] Based on sample of corporate entities classified in SIC codes 372 and 376, having as their principal activity the manufacture of aircraft, guided missiles, and parts.

[r] Revised.

INCOME ACCOUNTS
AEROSPACE COMPANIES

Calendar Years 1976–1980
(Millions of Dollars)

	1976	1977	1978	1979ʳ	1980
Net Sales	$31,828	$34,307	$41,689	$51,801	$60,207
Income from Operations	1,874	2,338	3,023	3,606	3,603
Total Income before Income Taxes	1,649	2,296	2,726	3,711	3,460
Provision for Federal Income Taxes	694	1,003	1,154	1,488	1,296
As a Percent of Total Income	42.1%	43.7%	42.3%	40.1%	37.5%
Net Profit after Taxes	1,091	1,427	1,816	2,614	2,558
As a Percent of Net Sales	3.4%	4.2%	4.4%	5.0%	4.2%
Net Profit Retained in Business	750	1,012	1,255	1,897	1,757

Source: Federal Trade Commission, "Quarterly Financial Report for Manufacturing, Mining and Trade Corporations."

NOTE: Based on sample of corporate entities classified in SIC codes 372 and 376, having as their principal activity the manufacture of aircraft, guided missiles, and parts.

r Revised.

The CHAIRMAN. Again, I don't have questions.

Mr. BEST. I would like the whole statement to appear as read.

The CHAIRMAN. It will in the record. But I guess at even a 3- or 4-percent return on a billion dollars, if you keep deferring the tax, it's not a bad deal after 4 or 5 years or 6 or 7. So I guess the percentage on the rate of return doesn't accurately reflect the true picture, and that's what we hope to get into with working with you, the staff of the joint committee, and Treasury. We are not trying to cripple the industry. We're trying to make certain that there's equity. We've got a real problem. If you look at the New York Times-CBS poll, it shows about 79 percent of the American people are concerned about the deficits. The deficits are not going to go away unless we do something. Everybody who comes to this committee says don't do it to me. I think you've a group coming in tomorrow you ought to get after.

I assume everybody here is opposed to repealing or modifying safe harbor leasing too. You are all opposed to the minimum tax. We understand that, but that doesn't mean we aren't going to do it because we are not going to lower deficits by just trying to calm every witness who comes before the committee. I assume your companies are worried about high interest rates too. Maybe not. Maybe that isn't a factor in the aerospace industry. But it is on the farms and in the cities and small businesses where we are not protected by Government contracts.

Mr. BEST. Mr. Chairman, I understand that point. If I thought that this change in accounting rules was going to make even a dent in resolving the budget dilemma, I might have had second thoughts. But from everything I have read, I am persuaded that it will not contribute to the solution to the budget problems, long term or short term, of this country.

The CHAIRMAN. That's one view. Of course, we are not talking $150 billion in this one little change. That's how much we would need. The deficit is going to be at least $150 or perhaps $175. If we don't increase revenues or cut spending, I guess it will stay at $150 billion, and everybody here can continue to pay higher interest rates, and inflation will come back, and we will have more businesses collapse. That doesn't mean that you have to come in here and volunteer. We don't expect it. Because I assume they could employ somebody else who wouldn't volunteer to have their taxes increased.

Mr. BEST. Well, I would like to volunteer some suggestions if you would like to hear them.

Senator CHAFEE. Well, I would just like to ask you one question on this matter. I notice one of your members is Lockheed. It's my understanding that Lockheed has still got the C-5A after 17 years under the completed contract cost accounting method.

Mr. NOLAN. That's not correct.

Senator CHAFEE. That's not correct.

Mr. NOLAN. No.

Senator CHAFEE. In other words, where do you draw the lines. For instance, on the F-4, if it's not in production. It certainly just ceased production. Some of these weapon systems prove durable and that is wonderful. They go on and on. Does the company just continue to defer the taxation on the moneys from this project until the thing is stopped?

Mr. **Nolan**. The answer is "no." Lockheed did not use the completed contract method for reporting its operation on the C-5A. Unfortunately, the C-5A resulted in a huge loss for Lockheed. And as a result of that, there wasn't any tax to pay. They didn't make any profit on building the C-5A.

Senator **Chafee**. Well, let's take another weapons system. McDonnell Douglas. Let's take the F-4. How long did that go on for?

Mr. **Nolan**. I'm not familiar with that particular program as far as the length of time.

Senator **Chafee**. All right. Mr. Best, you have some thoughts. Three minutes.

Mr. **Best**. Bipartisan effort was used to hammer out the congressional budget process. Though less than a perfect process, it does impose a discipline on a necessarily compartmentalized committee system. There is a real danger, I think, that unless there is a bipartisan effort, the whole budget process will come a cropper. Clearly, things have to be done on both the revenue and the expenditure side. I'm not suggesting that anything is sacrosanct. On the revenue side, I would favor an immediate imposition of an ad valorem tariff on imported oil from non-Western Hemisphere sources. I would favor the deregulation of natural gas with an appropriate severance tax. Those two measures alone would raise billions and billions of dollars and I believe would enhance our Nation's security.

I would favor eliminating the indexing provisions of the Economic Recovery Act of 1981. Since people are so concerned about the outyears, why don't we just eliminate that provision which doesn't take effect until 1985 until we see what the budget situation is at that time.

On the expenditure side, it would appear that the leadership is going to have to direct each committee to come up with some savings as of a certain date. There should be a real cost benefit analysis applied to each category of spending.

I'm not an expert on leasing. There may well be abuses in the area. I would think that at a time of great economic uncertainty, however, where there are threats of bankruptcies every day it might be a major mistake to eliminate this provision this year.

However, there are probably abuses because if people are paying less for what they are getting in forms of tax credits, that should be corrected. Perhaps caps should be put on it. Perhaps it should be given a 3-year life so that at the end of 3 years you can decide whether or not the economy justifies that type of safe harbor system.

Those are a few thoughts. But there are Republicans as well as Democrats who have proposed many of the things I mentioned this morning. Let me read just one thing from the Economist on this issue:

> The President's economic policy advisers will hold its quarterly meeting at the White House next Thursday. If its 14 members speak as plainly to the President as some of them have begun to speak elsewhere, Mr. Reagan may get an earfull.

Well, he didn't go to the meeting.

> On the side of raising more revenue through consumption taxes have been, Mr. Herbert Stein, Mr. Alan Greenspan, and Mr. Paul McCracken, all former chairmen of the President's Council of Economic Advisers. Energy levies also appealed to George Schultz, the Chairman of the Advisory Board, Mr. Walter Wriston, the chairman of Citibank, and Mr. James Lynn, the former Budget Director. . . . At a meeting last autumn, they gave their support to the idea of a temporary severance tax on natural gas as part of a strategy for accelerated decontrolled gas prices. But the White House . . . shelved the plan.

The report goes on.

> This is odd. The President is willing to delay decontrol of gas contracts contrasts with his determined lifting of oil price controls on January 28, 1981, 8 days after taking office.

The CHAIRMAN. We know all that. What are you going to do for your industry? You are giving us areas that touches everybody but the people you came to represent this morning. Is it your intention to divert our attention on other things we know aren't going to pass and thereby avoid scrutiny of the people you represent? If you say nothing is sacred, then are you suggesting a bipartisan package forged with the cooperation of Democrats as well as Republicans—you know, everything is fair game?

Mr. BEST. Yes.

The CHAIRMAN. Including the interest of the people of this panel.

Mr. BEST. That's right.

Senator SYMMS. Mr. Chairman, I asked a question of the first panel. And I noticed that Mr. Daniels testified on the Associated General Contractors. I was looking through your testimony, but did you say anything about the proposal that Drew Lewis has put forward for enhancing the highway trust fund?

Mr. DANIELS. It is not in my testimony. No, sir. AGC supports increased user revenue so that the highways can be improved. Yes, sir.

Senator SYMMS. Do any of the others of you want to comment on the proposition that Secretary Lewis has put forward on the Federal interstate trust fund to raise the fuel users fee 5 cents a gallon?

Mr. DANIELS. Excuse me, sir, but the point was made in earlier testimony that our highways are in great disrepair and all we need to do is drive on almost any highway.

Senator SYMMS. I can't imagine anybody in the business in the United States who puts a plant somewhere the roads go bad—that that wouldn't be successful.

Mr. DANIELS. I agree.

Senator SYMMS. I would think they are going to have to face that problem. And I'm surprised that that hasn't been one of the suggestions. In fact, as I have told the chairman of the Finance Committee, it's the only one that I've been in favor of that I have heard floated in this town yet. And I've got lukewarm feelings toward it. But it seems to me like at least we would get something back out of our expenditures.

Mr. Chairman, and all the witnesses that have testified this morning, I appreciate all of you giving your time and sharing your thoughts with this committee. And I do know we do have a big task ahead of us. I personally think, Mr. Chairman, that things probably are not quite as bad as the headlines of most of the newspapers are creating for us. And I think we are on the right track in the country. If we don't get faint hearted, I think we will be able to put a bipartisan coalition together. And I think the bipartisan coalition is growing that will close those outyear deficits. And I just hope that 90 percent of the outyear deficits are closed on the spending side by reducing spending. And only 10 percent at the maximum would be by increasing revenues. And I think we will see the economy recover if we can stick to that kind of a method.

The CHAIRMAN. Mr. Daniels.

Mr. DANIELS. I would like to go back to the subject of why we are here if I may just a moment. I'm speaking for the contracting industry. And we are for contractors. We are not against any other industry. We are for contractors. We don't think that we should be piggybacked on any issue and get into a situation that would be untenable for us simply because there are abuses. If companies using the completed contract method of reporting for income tax purposes now follow the present regulations, as my friend said, there can be no abuse. If there are abuses, the IRS should find the abusers and deal with them. The proposal—there are now four methods for reporting for income taxes purposes. I won't delineate them. You probably know them. The effort here is to add a fifth—progress payments. And to delete three others. The completed contract would be taken away, the cash basis would be taken away, the accrual basis would be taken away. So three of the present four methods would be taken away and a fifth one inserted. We are opposed to that. We don't think it makes much sense. And we thank you for listening.

Senator CHAFEE. Gentlemen, thank you very much for coming. We appreciate it.

This completes the hearing for today.

The CHAIRMAN. There's one this afternoon.

Senator CHAFEE. Excuse me. What time are we meeting, Bob?

The CHAIRMAN. Two o'clock on energy credits. Senator Packwood will preside.

[Whereupon, at 11:54 a.m., the hearing was adjourned.]

ADMINISTRATION'S FISCAL YEAR 1983 BUDGET PROPOSAL

FRIDAY, MARCH 19, 1982

U.S. SENATE,
SENATE FINANCE COMMITTEE,
Washington, D.C.

The committee met, pursuant to notice, at 2:01 p.m., in room 2221, Dirksen Senate Office Building, Hon. Bob Packwood presiding.

Present: Senators Dole, Packwood, and Matsunaga.

Senator PACKWOOD. The hearing will come to order please. We have three panels this afternoon; the latter two on energy credits. The first panel—I have a hunch that they are going to talk about, but I don't think it is energy credit—is Mr. Bob McNeill, the executive vice chairman of the Emergency Committee for American Trade; T. Lawrence Jones, president, American Insurance Association. And, gentlemen, if the two of you want to take the table now, we will move onto the other panels on energy when you are done.

We will operate under our normal 5-minute rule. Your entire statements will be in the record. And you can abbreviate them as you want.

Mr. McNeill, go right ahead.

STATEMENT OF ROBERT L. McNEILL, EXECUTIVE VICE CHAIRMAN, EMERGENCY COMMITTEE FOR AMERICAN TRADE, WASHINGTON, D.C.

Mr. MCNEILL. Thank you, Senator. I appreciate being here today on behalf of the Emergency Committee for American Trade on the administration's proposal to include DISC-deferred income as preferred income for purposes of a minimum corporate income tax. We would also like to comment briefly on the foreign tax credit which may become a factor in the consideration of a minimum corporate tax by this committee.

Our members are concerned with the proposal to subject DISC-deferred income to the 15-percent tax. I would guess that of the $600 billion in 1980 worldwide sales of ECAT member companies, that approximately $200 billion represented sales abroad through exports from the United States and from the sales of their foreign affiliates. Foreign markets are essential to our companies. For many of them, the DISC is a vital competitive tool.

Governments of our foreign competitors use a number of tax devices to assist exports. In many European countries, for example, the value-added tax is rebated directly to the exporter. A number of countries in Europe and elsewhere also use a territorial concept of taxation whereby up to 100 percent of export profits are exempted from taxation in the host country.

The U.S. system of taxing export profits leaves U.S. exporters at a competitive disadvantage since the effect of the DISC is to defer U.S. tax on about 20 percent of export profits. Subjecting deferred DISC income to a 15-percent minimum tax, in our judgment, would be a step in the wrong direction insofar as the U.S. exports are concerned. Since deferred DISC income must, by law, be used for export purposes, any tax payments would diminish the export related assets and would presumably diminish U.S. exports themselves. DISC is the only U.S. tax rule reflecting a U.S. policy of encouraging exports. It already has severe limitations. As I just mentioned, only 20 percent of export income receives a tax benefit. And DISC benefits apply only to exports in excess of an incremental base period. That period covered a period of very high inflation. As inflation decreases, it will be increasingly difficult to simply meet the incremental requirement.

The special DISC rule contemplated in the administration's tax proposal would clearly undermine any commitment that we would like to see to a national export policy. Because other countries are likely to continue and perhaps even improve the special tax treatment provided their exports, we urge the United States to do the same in order to place our exporters on a competitive par with our competitors overseas.

A diminished DISC, as proposed by the administration, will produce an opposite result, and put us at a further competitive disadvantage.

While the foreign tax credit is not a part of the administration's tax proposal, we are concerned that it could be considered during congressional deliberation on the minimum corporate tax issue. Quite simply, the foreign tax credit provides that taxes paid to foreign governments can be offset against the U.S. income tax on the income earned abroad. The foreign tax credit system does not permit foreign taxes to be credited against U.S. taxes imposed on income derived within the United States. It allows the credit only against income earned overseas.

Without the foreign tax credit, profits earned abroad by foreign subsidiaries of U.S. firms would quickly disappear. Recognizing this, the United States and most of our trading partners use a foreign tax credit system to try to avoid double taxation. Some countries, the Netherlands for instance, doesn't tax foreign income at all. Thus, the U.S. system of the foreign tax credit is in complete harmony with the practices and rules of our trading partners.

To convert the credit into a deduction for purposes of a 15-percent minimum tax is fraught with danger since it would lead to double taxation and leave the American taxpayer with higher tax costs than his competitors. Such higher costs will result in lost business for American firms and their overseas subsidiaries. Losing foreign markets to the business enterprises of other nations could have disastrous consequences to the U.S. balance of payments and to the economic health of our country. Many billions of dollars of current exports from U.S. parents to their overseas subsidiaries could be lost as eventually could many billions of dollars of profits annually returned to the United States by overseas subsidiaries. Our economy would be poorer. Jobs would be lost. And prompt advantage would be taken by our competitors of an American retreat.

[The prepared statement follows:]

TESTIMONY OF MR. ROBERT L. McNEILL, EXECUTIVE VICE CHAIRMAN, EMERGENCY COMMITTEE FOR AMERICAN TRADE, BEFORE THE SENATE COMMITTEE ON FINANCE HEARINGS ON THE ADMINISTRATION'S TAX PROPOSALS

Friday, March 19, 1982

Thank you for the opportunity to comment on behalf of the Emergency Committee for American Trade on the Administration's proposal to include DISC-deferred income as preferred income for purposes of a minimum corporate income tax. We would also like to comment briefly on the foreign tax credit which may become a factor in the consideration of a minimum corporate income tax.

The Emergency Committee for American Trade is an organization of the leaders of 62 large U.S. corporations with substantial overseas business activities. In 1980, ECAT member companies had worldwide sales of about $600 billion and employed over 5 million workers. The companies are leading U.S. exporters and investors. They have a keen interest in the taxation of both foreign source and export income.

Our members are concerned with the proposal to subject DISC-deferred income to a minimum corporate income tax. Although ECAT member companies are among the largest and most successful companies in the United States, they are all subject to increasingly severe competition in the United States and overseas markets. I would guess that of the $600 billion in 1980 worldwide sales of ECAT member companies, approximately $200 billion represented sales abroad through exports from the United States and from sales of their foreign affiliates. Foreign markets are essential to us. For many of our companies, the DISC is a vital competitive tool.

Governments of our foreign competitors use a number of tax devices to assist exporters. In many European countries, for example, the value-added tax is rebated directly to the exporter. A number of countries in

Europe and elsewhere also use a territorial concept of taxation whereby domestic taxes are levied only against income earned in the taxing country. Under this system, income earned abroad generally is not taxed nor are export profits since the territorial system usually results in export profits being incurred abroad where the transfer of title takes place. One hundred percent of export profits thus can be exempt from taxation in the country of export.

The U.S. system of taxing export profits leaves U.S. exporters at a competitive disadvantage since the effect of the DISC is to defer U.S. tax on about 20 percent of export profits. The benefits of the DISC, therefore, while most helpful, do not come near to offsetting the tax benefits provided our international competitors in the world marketplaces. Subjecting deferred DISC income to a 15 percent minimum tax in our judgment is a step in the wrong direction. Since deferred DISC income must be used for export purposes, any tax payments would diminish export-related assets and presumably exports themselves. We obviously would like to see the DISC improved, which would facilitate U.S. exports at a time when they are most needed.

DISC is the only U.S. tax rule reflecting a U.S. policy of encouraging exports. It already has severe limitations. As just mentioned, only 20 percent of export income receives a benefit and there are numerous technical qualifications that must be met in order to establish a DISC. Most significantly, DISC benefits apply only to exports in excess of an incremental base period. That base period covered a period of very high inflation. As inflation decreases, it could be difficult to meet or exceed the base period. Finally, even the favorable cost recovery legislation of last year will reduce the relative amount of taxable income that has been earned by DISCs. Another special DISC rule of the kind contemplated in the Administration's tax proposal would clearly undermine any commitment to a national export policy.

Exports earn necessary foreign exchange to help pay for our imports. Exports also enable American manufacturers to compete in the home and foreign markets. Without exports, U.S. production runs would be considerably constricted with consequent cost increases. This would most certainly cripple our competitive abilities at home and abroad.

To illustrate the significance of manufactured exports and imports in the U.S. economy, U.S. manufactured exports as a percentage of domestic manufactured goods jumped from 8.8 percent in 1960 to 20.9 percent in 1979. In the same period, however, imports of manufactured goods jumped from 4.7 percent to 20.1 percent. While the percentage of exports more than doubled in that period, the percentage of imports more than quadrupled. Similarly, the U.S. share of world trade has steadily eroded over the past two decades while that of our major international competitors has steadily risen.

The United States' diminishing share of world trade is symptomatic of increasing international competition and indicates the need for effective measures to enhance our competitive abilities, including our ability to export. A consistent U.S. export policy is much to be desired. It would provide the measure against which to weigh such proposals as the one to subject DISC-deferred income to a 15 percent minimum tax.

Because other countries are likely to continue and perhaps even improve the special tax treatment accorded their exports, we urge the United States to do the same in order to place U.S. exporters in a competitive tax position with its foreign competitors. We believe that U.S. tax laws should be neutral internationally, i.e., that they should place American citizens on a par with their foreign competitors. A diminished DISC will produce an opposite result and we thus urge that the proposal to treat DISC deferred income as preference income for purposes of a corporate minimum tax not be accepted.

THE FOREIGN TAX CREDIT

While the foreign tax credit is not a part of the Administration's tax proposals, we are concerned that it could enter congressional deliberation on tax issues.

Quite simply, the foreign tax credit provides that taxes paid to foreign governments can be offset against the U.S. income tax on the income earned abroad. The foreign tax credit system does not permit foreign taxes to be credited against U.S. taxes imposed on income derived within the United States. It allows the credit only against income earned overseas. U.S. law and regulations determine what is U.S. source income and what is foreign source income.

The foreign tax credit is designed to avoid double taxation while ensuring that income earned abroad by U.S. firms shall be subject to the higher of either the United States or foreign tax rate. If the latter rate is the same or higher than the U.S. rate, then nothing is owed the U.S. Treasury. If the foreign tax rate is lower, then the U.S. Treasury is owed the difference between the foreign and the U.S. rate of 46 percent. In this manner, double taxation is avoided and the higher of the two tax rates is charged, thus removing taxes as an incentive for either foreign or domestic investment.

Without the foreign tax credit, profits earned abroad by foreign subsidiaries of U.S. firms - by being taxed both by the foreign and United States governments at generally prevailing tax rates - would quickly disappear. Recognizing this, the United States and most of the other industrialized countries of the world utilize the foreign tax credit. The few countries that do not utilize it -- for example, France and the Netherlands -- do not do so because they levy no tax on income earned abroad by their citizens. Thus, the U.S. system is in complete harmony with the practices and rules of our trading partners.

To convert the credit into a deduction for purposes of a 15 percent minimum tax is fraught with danger since it would lead to double taxation and leave the American taxpayer with higher tax costs than his competitors. Such higher costs will result in lost business for American firms and their overseas subsidiaries. Losing foreign markets to the business enterprises of other nations could have disastrous consequences to the U.S. balance of payments and to the economic health of our country. Many billions of dollars of current exports from U.S. parents to their overseas subsidiaries could be lost as eventually could many billions of dollars of profits annually returned to the United States by overseas subsidiaries. Our economy would be poorer. Jobs would be lost. Prompt advantage would be taken of an American retreat.

Senator **Packwood**. I think you are very wise to mention the foreign tax credit issue, and maybe even deferral of foreign source income or anything that may come to your mind. Because if the newly projected deficit figures that I hear rumored around today are correct, I think we may be looking for any income. And on a very short notice, could strike out in every direction, doing some unintended injury—it wouldn't be malicious—but unintended injury for a balance of payment through American companies operating here and abroad. Of course, you and I have been through this battle side by side on so many of these issues over the years that I am very familiar with your testimony. But I want to congratulate you on being alert to a subject that hasn't been raised, but could be raised very quickly.

Mr. **McNeill**. Thank you, sir.

Senator **Packwood**. I have no other questions. Thank you.

Mr. **McNeill**. Thank you.

Mr. Jones.

STATEMENT OF T. LAWRENCE JONES, PRESIDENT, AMERICAN INSURANCE ASSOCIATION, WASHINGTON, D.C.

Mr. **Jones**. Yes, sir. I'm Lawrence Jones, president of the American Insurance Association, Senator Packwood——

Senator **Packwood**. Let me say to Mr. McNeill that you are welcome to stay if you want.

Mr. **Jones** [continuing]. An association representing 152 property casualty insurers which write approximately one-third of the property-casualty insurance in the United States.

We are pleased to have this opportunity to comment on the tax proposals before the committee. Particularly, the minimum tax on corporations, and the increases in the minimum deposit requirements for estimated taxes. We appreciate the fact that our written statement will be entered into the record.

We realize that you have been sitting here for several days and have had the broad picture presented to you by a number of witnesses, so we would like to concentrate on the minimum tax as it relates to a property-casualty insurance company and to the other issue of the increase in the minimum deposit requirement.

The administration has proposed eight changes, and two of those have an adverse impact on the property-casualty insurance companies which may have been unintentional. The administration proposes to replace the current add-on minimum tax with an alternative tax for corporations equal to 15 percent of their alternate tax base in excess of $50,000. The new minimum tax would be composed of the corporate regular tax plus certain preference items which are applicable to certain industries.

However, in computing the corporate minimum tax base, no deduction would be permitted for net operating loss carryovers and carrybacks. Although credits for the minimum tax paid would be permitted, the amount of any net operating loss deduction in computing the regular corporate tax would be deemed to be absorbed.

By disallowing the net operating loss deduction, the designers risk imposing the minimum tax on a marginally profitable corporation or one which is only beginning to recover for a loss period.

For a cyclical industry like property-casualty insurance, this unwillingness to recognize a corporation's real economic circumstances may force a corporation to pay a tax at a time when it would be more desirable to allow it to recover from its losses. In our case, from underwriting losses.

The administration states that the amount of tax collected under the proposed minimum tax and the regular corporate income tax will be the same as under current law. The argument that these changes represent a mere timing change overlook the impact of the tax on a corporation's cash flow. Contrary to the clear intent of the economic and tax policies adopted last year, funds which might have been devoted to investments in plants and equipment will be diverted.

Individual companies in our association have found that the new minimum tax may be imposed upon them just when it is most difficult for them to assume—in the early years of the recovery from our underwriting losses.

We are disturbed by the pattern of taxation which emerges when last year's tax changes and this year's proposals are viewed together. The benefits from the new 10-5-3 depreciation measure—the centerpiece of last year's corporate tax reductions—were allowed primarily to capital intensive industries. The minimum tax, with its nonrecognition of net operating losses, is expected to have an adverse impact upon financial and service industries as well.

Our members are concerned that these measures, taken together, will result in an unfair and perhaps unintentional redistribution of the corporate tax burden among various industries. The contributions of the service industries, such as insurance, banking and real estate, to the domestic economy and international trade are substantial. They accounted for 14.4 percent of the GNP in 1979.

While we support the administration's effort to promote investment and restore productivity, we believe it's critical that the Congress should not shift a disproportionate share of the corporate tax burden to financial and service industries.

Senator Packwood, our industry has a great deal of difficulty in calculating in the first quarter what their profits would be in total for the year. And what we have asked about the accelerated deposit for estimated tax is that the percentage required to avoid the penalty in the first quarter be less than that in the second, third, and fourth quarters. In other words, there ought to be a differential between the minimum estimated and the third and fourth quarter in particular. And we ask special consideration from the committee. It would be particularly relevant to us, but we are sure there are other industries affected, too. We haven't gone out and examined what other industries would need that. But with all of our offices spread everywhere, with catastrophes arising in the third and fourth quarters, we cannot make very accurate estimates. And with pools and syndicates operating and not reporting their profits or their estimates until after 6 months, it would be the second quarter before we could have fairly accurate estimates prepared.

[The prepared statement follows:]

STATEMENT OF T. LAWRENCE JONES, PRESIDENT OF THE AMERICAN INSURANCE ASSOCIATION

Mr. Chairman and members of the Committee, I am T. Lawrence Jones, President of the American Insurance Association, a trade association representing 152 property and casualty insurers which write approximately one-third of the property-casualty insurance premiums in the United States. I am pleased to have this opportunity to comment upon the Administration's tax proposals that the Committee is considering as part of its review of tax and spending measures for FY 1983.

* * *

The Economic Climate

Last year, when this Committee considered the various tax proposals which became the Economic Recovery Tax Act of 1981, it was faced with grave economic circumstances. The expenditures of the federal government had grown rapidly over the previous decade, outpacing the growth of the GNP. In FY 1980, for example, federal expenditures rose by more than 17% over the previous year, while GNP rose only 8.8%. The continued requirements for federal revenue placed growing demands upon individuals and business for additional tax revenues.

By FY 1981, federal tax receipts amounted to 21 percent of GNP, the highest ratio since World War II. As the federal sector grew its financing and taxing activities drained income from capital investments necessary to maintain the nation's productive capacity.

Both inflation and high interest rates impaired the healthy growth of the economy. The willingness of Congress to deal with these deep-rooted problems was demonstrated by the enactment of significant cuts in federal spending and much needed incentives for savings and investment in the tax law. It appears that the increases in federal spending, which had appeared to be almost uncontrollable, have been checked. The Congressional Budget Office estimates that federal expenditures will rise by only 12.6% in FY 1982, and 9.3% in FY 1983, a welcome drop from the 17.4% increase of FY 1980 and the 14% of FY 1981.

These reductions have been followed by a heartening reduction of the rate of inflation in the past few months.

The redirection of federal economic policy was accompanied by significant changes in federal tax policy. The Congress sought to promote capital investment, expand employment, and make American goods and services more competitive in world as well as local markets, through new incentives for business investment -- principally accelerated depreciation and investment credit measures -- and individual savings -- the expanded IRA's and "All Savers" certificates. These shifts in tax policy were intended to chart a course for business planning over the next five years, at a minimum, and, if economic conditions warrant, for an even longer term.

Our member companies have welcomed these new directions in tax policy and believe the Administration's commitments to reduce the growth of the federal budget and to provide tax incentives to business development are essential if we are to restore the health of our economy.

The Pressures Created by the Deficit

But the prospect of benefits from this new course is clouded by projections of a federal deficit of $90 and $120 billion, in the estimates of the Administration and the Congressional Budget Office. A deficit of this magnitude creates such concern in financial markets that the course charted last year is threatened by measures proposed for its reduction.

We believe these concerns are legitimate. Low rates of growth in the GNP over the past decade have shown that the economy can no longer bear the costs of ever-expanding government financing or steadily increasing taxes.

But in designing a strategy for control of the deficit, we believe it is important not to abandon the basic principles of the policies adopted only last year. The fundamentals of the new tax and economic policies are sound. Reducing the burden of corporate taxes and continuing the new savings and investment incentives are essential.

While these policies are expected to produce substantial improvements in the economy in the near future, it would be premature to expect to see their full benefits in the most recent monthly indices. The form and scope of these investment incentives should be maintained if business planners and private investors are to feel that they can rely upon projected returns from investments. Investors such as insurance companies, whose reserve calculations depend upon projections extending over a number of years, cannot afford to make commitments that depend upon current savings and investment incentives when it appears that these incentives may soon be eliminated or reduced.

We urge that Congress pursue cuts in spending as an alternative to increases in corporate and personal taxes which would blunt the effect of last year's changes. Careful examination of all federal programs is needed, particularly the proposal for rapid increases in the defense budget. While few Americans question the need for a strong defense, there are many who wonder whether such a rapid increase can be managed efficiently.

The Minimum Tax

The Administration has proposed eight changes in the law to raise additional revenue. Two of these would have an adverse impact upon property-casualty insurers -- the alternative minimum tax on corporations and the accelerated deposit requirements for estimated corporate income taxes.

The Administration proposes to replace the current add-on minimum tax with an alternative minimum tax for corporations equal to 15% of their alternative tax base in excess of $50,000. The new minimum tax base would be composed of a corporation's regular taxable income plus certain preference items.

However, in computing the corporate minimum tax base, no deduction would be permitted for net operating loss carryovers and carrybacks. Although credits for the minimum tax paid would be permitted, the amount of any NOL carryover or carryback allowable in computing the regular corporate tax will be deemed to be "absorbed," according to the Administration, "even in years in which the corporation pays the corporate minimum tax instead of the regular tax."

By disallowing the net operating loss deduction, the designers risk imposing the minimum tax on a marginally profitable corporation or one which is only beginning to recover from a loss period. For a cyclical industry like property-casualty insurance, this unwillingness to recognize a corporation's real economic circumstances may force a corporation to pay an additional tax at a time when it would be more desirable to allow it to recover from its losses.

Assurances that the amount of tax collected under the proposed minimum tax and the regular corporate income tax will be the same as under the current law -- the argument that these changes represent a mere "timing" change -- overlook the impact of the tax on a corporation's cash flow. Contrary to the clear intent of the economic and tax policies adopted last year, funds which might have been devoted to investments in plants and equipment will be diverted.

Individual companies in our Association have found that the new minimum tax may be imposed upon them just at the time when it is most difficult to assume -- in the early years of recovery from a loss period. Business cycles in this industry have typically extended for five to seven years, with the return to widespread profitability marked by sharp competition among companies for market share. To impose an additional tax burden at the first sign of recovery may distort the traditional course of this cycle. Viewed from managements' perspective, the period of marginal profitability will only be prolonged.

While the impact of the minimum tax upon the business cycle and company operations is a source of particular concern to us, we cannot help but be dismayed by the shift in distribution of the tax burden among industries, as well. The accelerated depreciation provisions adopted last year were designed to benefit primarily manufacturers and other industries requiring substantial investments in plants and equipment. Only a small percentage of these benefits were allocated to financial and service industries.

Yet the contributions of service industries such as insurance, banking, finance,and real estate to the economy are substantial. They rank behind only manufacturing and distribution (wholesale/ retail trade) in terms of their share of GNP (see chart attached). In 1979, the latest year for which Department of Commerce statistics were available, banking, insurance and real estate accounted for 14.4% of the GNP.

Our members are concerned that tax changes intended to restore productivity do not result in an inequitable -- and perhaps unintended -- redistribution of the corporate tax burden among industries. Benefits from the new accelerated depreciation provisions -- the centerpiece of last year's corporate tax reductions -- were allocated primarily to capital intensive industries. The minimum tax is expected to fall upon service industries as well, to an extent which the Treasury concedes is difficult to specify. The distribution of tax benefits and burdens among industries, if these two measures are considered together, is unquestionably a source of concern to our members. While we have supported the Administration's efforts to promote investments and restore productivity, we believe that it is critical that the Congress not shift a disproportionate share of the corporate tax burden to financial and service industries.

Accelerated Deposit of Estimated Taxes

The Administration has proposed that the minimum requirement for deposit of estimated corporate taxes be increased yet again. Amendments to the deposit requirement added in 1980 and 1981 set progressive increases in the minimum amounts due if a corporation is to avoid the payment of penalties. Although the statute provides three exceptions which would relieve a corporation of penalties, large corporations (those having over $1 million of taxable income in any of the three preceding taxable years) can satisfy the deposit requirement only if they pay a fixed percentage of their tax liability for the current year. For 1981 the minimum is set at 60%. By 1984 it is scheduled to rise to 80%. The Administration proposes to increase the minimums to 85% in 1985 and 90% in 1986. Installment payments of the estimated tax are due on the 15th day of the 4th, 6th, 9th, and 12th months of the year.

With the removal of two of the exceptions to the penalty and the steady increase of the minimums required, corporations which wish to comply with the deposit requirement are faced with a need to predict income, losses, and earnings with speed and accuracy. For property-casualty insurers, however, it has proven difficult -- indeed, impossible -- to predict the year's earnings accurately enough to satisfy the deposit requirement for the first quarter.

Even with sophisticated management information systems, the data produced during the first three months of the year does not provide an adequate basis for projections of the year's results. Moderate and large-sized insurance companies receive premiums through a network of agents and brokers spread throughout many states. Claims, too, are evaluated and paid through widely dispersed claims settlement representatives. These reports from the field, which are the basis for projections of underwriting income and losses, are difficult to assemble because the sources are numerous and widely dispersed.

It is also the practice in the industry for pools and associations not to report on underwriting activities for the first six months of the year. Companies which receive a substantial portion of their business through pools and associations and foreign agents and brokers are simply unable to estimate the size of tax payment necessary to avoid penalties.

Finally, payments of corporate tax are difficult to estimate in the first quarter because insurers are subject to wide fluctuations in losses incurred during the third and fourth quarters which may turn an otherwise profitable year into a loss.

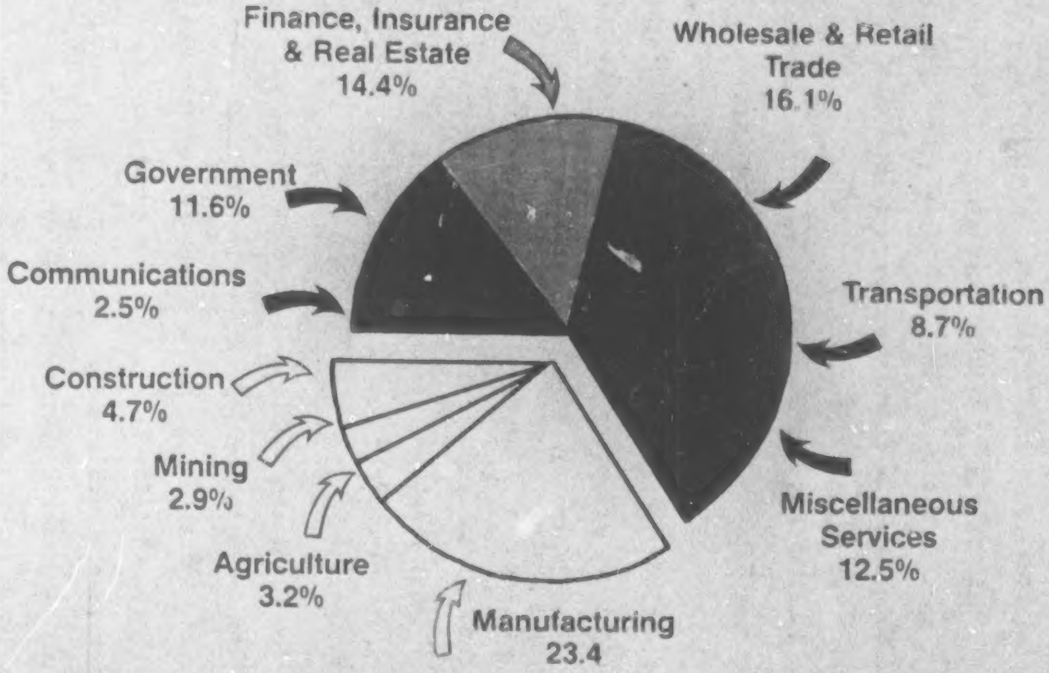
Catastrophic losses -- a hurricane on the Gulf Coast, the loss of an oil drilling rig or a jumbo jet, a court's verdict in a precedent-setting class action -- are only a few examples of losses incurred in the third and fourth quarters which may upset an insurer's earnings projections.

Our member companies's inability to collect sufficient first quarter data is not caused by an unwillingness to comply or a failure to institute necessary information gathering systems. But fluctuations in claims incurred and the difficulties of collecting information from a large number of widely dispersed sources make it impossible to predict annual results on the basis of data as slight as that received during the first quarter. Current law forces many companies to make the hard choice between a penalty and an overpayment in the first quarter. Raising the minimum from 60% to 90% will make this an even greater hardship.

If the Committee should decide to adopt the Administration's proposal to increase the deposit requirement even further, we ask that the increase be applied to the three later quarterly payments only, with the first quarter's payment carved out at some lower level, such as 60%.

As an alternative recommendation, we ask that the Committee permit a longer period for taxpayers to compute the first quarter payment. Imposing nondeductible penalties for underpayment of estimated taxes upon businesses that have made good faith efforts to comply seems neither fair nor reasonable.

COMPOSITION OF GROSS NATIONAL PRODUCT
1979



Shaded Areas=Services

Source: U.S. Dept. of Commerce, Bureau of Economic Analysis

Senator PACKWOOD. Let me ask you this question. Most of the hearings on the minimum tax issue this week have been a series of witnesses of "not us." And they have a justifiable reason in each of their industries as to why it should not apply in some particular fashion to them. But the upshot of it will be it won't apply to anybody, because each industry will have made a case to exempt them.

What do you think Congress should do if this is the situation? If the deficit is going to be bigger than anything that has been projected yet for 1982 and 1983, and if the President says he will not accept any change at least this year in any adjustment of social security, will not rollback any of the individual tax cuts, and will not accept anything less than what he has said he wants for defense, and Congress thinks the deficit is infinitely too high, what should we do?

Mr. JONES. The proposal for the minimum tax is really designed to address some of the results of the tax that was passed in 1981.

Senator PACKWOOD. Let me stop you. Here I am not addressing that to the minimum tax. You and I know how relatively little money it raises.

Mr. JONES. Yes.

Senator PACKWOOD. What should we do about the bigger problem I asked about?

Mr. JONES. You have to go back to those things that were put out of bounds by the President. You have to reduce expenses in some way.

Senator PACKWOOD. Why don't you go tell him that?

Mr. JONES. Our insurance companies didn't get together and make formal policy on what expenses should be reduced in the Federal Government. But from talking to a number of the chief executives, I could say that there is a consensus or feeling that the increase in the expenditures in the Defense Department should be spread out more. Not necessarily dropped, but pushed back, to cut substantially the increase. And that we are not experts on whether the other expenses of the Federal Government should be decreased. But there probably are some. And you gentlemen are much more in a position to determine those.

I think it is recognized that there are some abuses that have come out of the 1981 tax act that possibly should be addressed by this committee. You might cap the leasing provisions that were permitted under the 1981 act. The capital intensive industries were the ones that got the benefit of tax decrease. We are labor intensive. And so we would not want an adjustment to the capital intensive industries to inadvertently fall on the labor intensive industries.

Senator PACKWOOD. Well, as I said to Mr. McNeill, you are wise to use the word "inadvertent." Because I have been on this committee long enough to know that we make unintentional mistakes. It is not done maliciously.

Mr. JONES. Yes.

Senator PACKWOOD. Quite often it is not even caught when we pass legislation. It's not caught by the lobbyists for the affected industries. They don't initially grasp the effect. I think of carryover bases which passed relatively easy without most of us understanding the consequences of it.

I have no other questions. Thank you very much for waiting. I know we had to put you off for a while to get you on this afternoon. And I appreciate it.

Mr. **Jones**. Thank you very much.

Senator **Packwood**. Now let's go with a panel of Michael Zimmer, David Hallberg, and Richard Hanneman. Who wants to go first? You want to start, Mr. Zimmer?

Mr. **Zimmer**. I will be glad to, Mr. Chairman.

STATEMENT OF MICHAEL J. ZIMMER, WASHINGTON COUNSEL, COGENERATION COALITION, INC., WASHINGTON, D.C.

Mr. **Zimmer**. My name is Michael Zimmer, Mr. Chairman. I am representing as Washington counsel, today, the Cogeneration Coalition. It's a nonprofit organization established in 1980 by a number of interested companies supporting the development of cogeneration resources nationwide.

Senator **Packwood**. Do we have a statement of yours? I don't have Mr. Zimmer's statement. Go right ahead.

Mr. **Zimmer**. As I was saying—established in 1980 by a number of companies with interest in the development of cogeneration prospects within the country, at that time, under the leadership of a former Member of the Congress, Richard F. Vander Veen. Since then the coalition has established advisory relationships with other public interest and trade association groups on cogeneration and energy efficiency issues.

We come to these hearings today, Mr. Chairman, with the benefit of a minimal period of 2 years of experience with the cogeneration tax credit provided by this committee in 1980—particularly, under the strong leadership that was brought to bear on that issue by yourself, Mr. Chairman, working in this area along with other tax credits affecting alternate energy development.

Since that period of time, the cogeneration tax credit has not been the subject of any implementing efforts, guidelines by the Treasury Department. This has created some degree of uncertainty regarding the capability to avail oneself of that credit, coupled with the short time period that was affixed to the availability of the credit, scheduled to expire the last day of this year in 1982.

We submit that time is now of the essence in sending a signal of stability and continuity to ratepayers, commerical and industrial users, equipment manufacturers, project developers, engineering design firms, and gas and electric utilities that have a stake in the outcome of using energy efficiently through cogeneration. This signal must entail extension of the tax credit through December 31, 1986 for cogeneration property for several critical reasons. No. 1, diminishing cash resources, financing options and high interest rates face energy users investing in energy efficiency improvements since 1978. The condition in this regard is worsening. No. 2, the need for continuing stimulation of these types of investments is paramount in light of continuing decline in domestic fossil fuel supplies, of oil and natural gas, and projected shortages in electric capacity nationwide during this decade. No. 3, the group believes that after normal business, investment factors are considered, the availability of a business energy tax credit could make a crucial difference in the investment decisionmaking process for energy efficiency improvements within the corporation.

Four, reduced energy costs have the potential to reduce the tax deductions for energy operating expenses as well as generating increased economic activity from industries that provide energy efficiency equipment and services. A recent calculation conducted by one of our members just on the issue of whether or not the tax credit should be made available to oil and gas equipment, leads to a conclusion that such a decision, if entertained by this committee over the next 4-year period, would lead to an increase of equipment purchases in this area of over $2 billion, with the prospect of 10,000 additional jobs just in the equipment manufacturing industries alone. This calculation does not take into account other prospects in the financing, consulting, and design aspects of this business.

A fifth point, Mr. Chairman, is that the depreciation modifications recently enacted last year will not necessarily prove sufficient to affect these decisions with respect to cogeneration investments. A number of these types of equipment did not have class lives under the ADR system prior to the enactment of the recent accelerated cost recovery system in the Economic Recovery Tax Act. The R. & D. tax credit does not help this line of business because we are dealing with technology that is already established and in place and ready to go.

Finally, the continuation of the business energy tax credit program may, in fact, be more of an effective revenue enhancement measure than seeking its outright repeal, or permitting its expiration. This inclusion has been discussed in terms of the reduction in offsetting deductible expenses for energy costs, as well as the offsetting consideration associated with the increased business activity from these projects creating revenues and income that is taxable to the Federal Government.

We appreciate the opportunity to appear before this committee on this issue, and respectfully request your consideration of the specific points raised in our statement.

[The prepared statement follows:]

Summary Statement
of the
Cogeneration Coalition, Inc.
before the
Senate Finance Committee
March 19, 1982

- The Cogeneration Coalition, Inc. views with alarm and strongly opposes any attempt to rescind or discontinue the business energy tax credit provisions of the Internal Revenue Code.

- The Coalition supports the extension of the business energy tax credits, subject to certain modifications affecting the cogeneration tax credit. Such an extension should be a part of any major tax legislation enacted during this session of the 97th Congress.

- Short-term stimulation of energy conservation is desirable, and experience with the investment tax credits since 1962 has shown this approach to be effective in stimulating desirable capital investment.

- The availability of business energy tax credits will not precipitate premature replacement of old equipment since a tax credit will not substitute for sound and responsible business judgment. In light of the current business and investment climate, the business energy tax credit will serve the critical function of elevating energy efficiency improvements to a higher level within corporate planning and decision-making.

- The business energy tax credit offers opportunities to increase tax revenues within a relatively brief period of time through positive feedback effects from reduced deductible expenses and permanent increases in desirable economic activity associated with providing energy efficiency improvements to industrial users.

- The current cogeneration tax credit should be improved in light of its pending expiration on December 31, 1982. Such improvements should recognize that in the short-term cogeneration investments where applicable offer the greatest promise for increased energy savings when compared with other energy efficiency technologies.

- Such improvements should include extending the current cogeneration tax credit to December 31, 1986; modifying the definition of cogeneration equipment; making the credit available for equipment installed in new facilities as well as for the total costs of the cogeneration system installed; providing the tax credit for oil and gas-fired cogeneration equipment; and removing the current public utility property exclusion for the credit.

- Finally, the Coalition recommends that any modifications to the safe harbor leasing provisions of the Economic Recovery Tax Act should specifically recognize the value of this financing tool to small business alternate energy project development, including cogeneration facilities. The financing of such projects through the safe harbor lease should be specifically grandfathered from any future modifications or amendments.

Introduction

The Cogeneration Coalition, Inc. ("Coalition") is a non-profit organization comprised of interested gas utilities, industrial users, equipment manufacturers, project development companies, and engineering consulting firms.[*] The Coalition has also established advisory relationships with other public interest and trade association groups on cogeneration and other such energy efficiency issues. The Coalition has supported since 1980 the provision of necessary financial and tax incentives to promote the utilization of cogeneration resources and the removal of unnecessarily restrictive federal barriers to the development of potential cogeneration resources nationwide.

The Coalition views with alarm and strongly opposes any attempt to rescind or discontinue the business energy tax credit provisions of the Internal Revenue Code, particularly in view of the diminishing cash resources, financing options, and high interest rates facing energy users investing in these energy efficiency improvements since 1978. In light of these current circumstances which have grown more severe since enactment of this program in 1978, as amended in 1980, the business energy tax credits should be extended through December 31, 1986.

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[*] The current members of the Cogeneration Coalition, Inc. include: Kimberly Clark Corp., Brooklyn Union Gas Company, Great Lakes Carbon Company, H.O. Penn Machinery Co., National Urban Energy Corp., Daverman & Associates, Energenics Systems, Inc., Catalytic Engineering, Inc., Entek Research, Inc., and Williams & Works' Industrial Co-Energy Systems.

The Cogeneration Tax Credit Should Be Extended

Energy efficiency is clearly receiving a lower priority than energy supply incentives under the Reagan energy and tax programs. Fuel use restrictions have been replaced by policies promoting free choice, oil regulation replaced by decontrol, mandatory conservation displaced by market forces and prices, coupled with tax provisions such as the Accelerated Cost Recovery System for promoting business productivity investments and national economic recovery. The national energy policy debate has also shifted from intense evaluation of international considerations to U.S. budgetary concerns. The Cogeneration Coalition believes that the present business energy tax credits not only contribute to the long-term national objective of lowering oil imports and stimulating national economic recovery but also present some sound and pursuasive arguments for continuation that will satisfy even the most conservative budgetary proposals presently under scrutiny.

The Windfall Profits Tax Act of 1980 ("Act") (P.L. 96-223) provided for the establishment of an energy investment tax credit for cogeneration equipment*/ in the amount of 10% beginning January 1, 1980 through December 31, 1982. To qualify for this tax credit, the equipment must be installed at an industrial or commercial facility in existence by 1980. There are further qualifications: the system cannot use oil or natural gas or any of their products as a primary fuel; if such fuels are used for startup, backup, or flame stabilization purposes, they cannot exceed 20% of fuel consumption by the system. Nor does equipment that merely increases a system's capacity to generate a primary energy product qualify under the Act.

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*/ Section 48(l)(14) of the Internal Revenue Code.

During the FY 1982 budget process, this Administration strongly supported the energy tax credit program as one of the cornerstones of its national energy policy.*/ Its recent change in position for FY 1983 appears more motivated by budget concerns than based upon sound business and energy policy considerations. Such short-term policy shifts should be rejected by the Congress. Increasing energy efficiency is still viewed by many as one of the more effective, inexpensive, environmentally sound and permanent methods of offsetting oil dependency and reducing international vulnerability during the upcoming decade. The need for continued stimulation of such investments is paramount in light of the continuing decline in domestic fossil fuel supplies and forecast shortages in electric capacity projected for this decade.

Thus, short-term stimulation of energy conservation is desirable. Experience with investment tax credits since initial passage in 1962 has shown this approach to be effective in stimulating desirable capital investment. In House Report No. 95-1445, the House Ways and Means Committee stated "investments have increased when the credit has been made available and decreased when the credit was rescinded."**/

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*/ A Program for Economic Recovery (February 18, 1981), p. 4-20.

**/ Industrial Energy Efficiency and Fuel Conversion Tax Incentive Act; Hearing before the Subcommittee on Taxation and Debt Management Generally of the Senate Committee on Finance, 96th Cong., 2d Sess. 65 (1980).

As previously noted by the National Association of Manufacturers before this Committee (Id. at 65):

> "Capital expenditures increased in the years following the original enactment in 1962 and again picked up after restoration of the credit in 1971 in the years following when the ITC was raised to the 10% level"

While the regulatory components of the Reagan energy strategy are sound, the economic and tax provisions may not do the crucial job of promoting gains in energy efficiency. Such efficiency losses will inure to the detriment of all ratepayers, industrial and commercial users, equipment manufacturers, project developers, engineering design firms, and both gas and electric utilities. The energy users with the greatest incentive to conserve the use of oil, natural gas and electricity are also the very same companies and users that lack sufficient capital to take full advantage of readily available energy-efficiency technologies. Recent analysis has illustrated sharpening pressures on pretax profits caused by escalating fuel and power costs from 17.1% of pretax profits in 1966 to 39.5% of pretax profits in 1978.[*] (See Attachment 1)

There are those who also argue energy tax credits precipitate premature replacement of old equipment. First, capital outlays for new equipment will not be solely contemplated on the availability of a tax credit. Higher energy costs, technical considerations, increased productivity, and other factors are additional incentives to purchase more efficient equipment. However, after these factors are evaluated, the availability of a business energy tax credit could make the crucial difference in a final investment decision within the corporation. Second, these purchases fit neatly into the Reagan Economic Recovery Program, pumping more money into the economy, creating more jobs, new businesses, and desirable economic growth.*/ Third, the tax credit itself may not per se guarantee capital intensive outlays on the part of industry but could be a definite quantum in the overall decision-making process. There may be old and marginal, but still quite operative facilities, that a tax credit incentive could possibly promote replacement investments with modern energy efficient devices.

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[*] "Fuel and Power Costs Compared With Pre-Tax Profits," Energy User News (September 14, 1981), p. 17.

In other words, a tax credit is not a substitute for sound and responsible business judgment. In a basic commodity industry that requires high investment for a historically low rate of return, the additional tax incentives provided would clearly help stimulate timely capital investments. Such investment in energy efficiency technology would save significant amounts of energy in the long-term and dampen the inflationary effects of rising energy costs.

With respect to concerns voiced by the Treasury Department, in contrast to some tax incentives, the business energy investment tax credit offers opportunities to increase tax revenues within a relatively brief time. Tax credits can be tied to actual energy savings as in S.750.**/ Energy expenses are deductible expenses under Section 162 of the Internal Revenue Code as "ordinary and necessary" business expenses. Reduced energy costs have the potential to reduce tax deductions in deriving taxable income with positive feedback effects offsetting revenue losses from the tax credits themselves.[*/] Further, the increased economic activity associated with the enhancement of energy efficiency generates additional taxable income with further positive feedback effects. This means that for every dollar of energy use saved by the investment, the Treasury in effect recovers increased tax revenues--revenue which would not have been collected but for the energy saving capital expenditure. Thus, continuation of the business energy tax credit program may in fact be more of an effective revenue enhancement measure than seeking its repeal or permitting its expiration.

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*/ For instance, the potential applications for cogeneration are rather extensive including industrial facilities, alcohol fuel plants, water purification, desalinization and agricultural facilities, multi-family residential buildings. universities, hospitals, military bases and municipal district heating systems.

**/ S. 750 introduced by Senator Malcolm Wallop on March 19, 1981 (126 Cong. Rec. S.2393) and co-sponsored by 18 members of the Senate.

The Cogeneration Tax Credit Should Be Improved

The energy tax credit for cogeneration investments expires on December 31, 1982. It is not only the position of the Cogeneration Coalition that this credit should be extended, it is also our position that the energy tax credit should be amended to promote a comprehensive scheme for the short and mid-term development of cogeneration as a matter of national energy and tax policy. The current business energy investment tax credit for cogeneration equipment is too restrictive, and fails to recognize that in the short-term cogeneration investments

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[*/] Several recent studies have confirmed this contention which the Treasury Department continues to ignore. Arthur D. Little Company recently concluded in a study that revenue gains and losses for energy tax credits would balance with each other - if the present 15% tax credits for renewable energy resources were extended to 1991 and conventional fuel prices rose by 11% per year. Washington Resources, Inc. has concluded in a special study escalating fuel prices are a critical factor in determining the revenue effects of energy tax credits.

where applicable offer the greatest promise for increased energy savings compared with other energy efficiency technologies. As summarized, cogeneration equipment to qualify under current law must be installed in connection with a boiler or burner at an existing facility and must result in an expansion in the facility's cogeneration capacity. The annual use of oil or natural gas fuel in the systems must be less than 20% of all fuel used each year and must be limited to use as a startup, backup or flame stabilization fuel.

The Cogeneration Coalition specifically recommends that the cogeneration tax credit should be amended and extended to December 31, 1986 to include the following:

A. Modify the definition of cogeneration equipment to ensure that mechanical cogeneration qualifies for this tax credit, as well as cogeneration equipment that uses energy sources such as solar, biomass and geothermal energy.

B. Make the business energy tax credit available for cogeneration equipment installed in new facilities as well as modification or retrofit of existing facilities. New facilities are generally better-suited for cogeneration than the retrofitting of existing facilities. Such new facilities can be constructed from the outset to avoid numerous technical problems which are faced in the modification and retrofit of existing facilities.

C. Make the business energy tax credit for cogeneration equipment available for the total costs of the cogeneration system installed. The current business energy tax credit for cogeneration is limited to equipment which increases a system's capacity to produce electricity or useful energy, whichever is the secondary energy output of the system. Specifically, the credit should also be available for any pollution control equipment or loading and handling equipment required in connection with the cogeneration facility.

D. Ensure that the business energy tax credit for cogeneration equipment is available for oil and gas-fired equipment installed in a cogeneration facility. Omitting oil and gas or any of their products as primary fuels for purposes of this energy tax credit is counterproductive since the most effective and currently available cogeneration technologies are oil and gas-fired. Current restrictions on use of oil and gas in cogeneration facilities in order to qualify for available federal tax incentives must be reexamined to recognize that only large-sized cogeneration facilities possess the economies of scale and capital requirements to utilize coal. Furthermore, the only reasonable and available fuel choice in the interim is oil and gas for small and medium-sized cogeneration facilities. Use of oil and gas in a cogeneration facility offers increased efficiencies in use of these fuel inputs over use of such fuels in separate facilities. Also, the use of oil and gas in the interim can provide an important bridge or transition to synthetic fuels derived from wood, lignite, etc., for the long-term use in cogeneration applictions.

E. Remove the current exclusion against public utilities qualifying for the business energy tax credit for cogeneration equipment, which is characterized as public utility property.

F. Require the Department of Treasury to promulgate proposed regulations to implement these modifications within 90 days after the date of enactment.

Legislation currently before this Committee considers these recommendations in part particularly in provisions of S.750. Hearings were already held on this legislation before the Senate Finance Subcommittee on Energy and Agricultural Taxation on October 19, 1981. This Committee already has a record before it on the business energy tax credits to act decisively as part of its consideration of the tax proposals in the Administration's FY 1983 budget. The extension of the business energy tax credits would be fundamentally consistent with the goals and objectives of the FY 1983 budget effort.

Conclusion

The Cogeneration Coalition submits that time is of the essence in sending a signal of stability and continuity to the ratepayers, industrial and commercial users, equipment manufacturers, project developers, engineering design firms, and gas and electric utilities with a stake in the outcome of this issue. This signal must entail extension of the business energy tax credits through December 31, 1986 for several critical reasons:

1) diminishing cash resources, financing options and high interest rates face energy users investing in energy efficiency improvements since 1978;
2) the need for continued stimulation of such investments is paramount in light of the continuing decline in domestic fossil fuel supplies and projected shortages in electric capacity projected for this decade;

3) after normal business investment factors are considered, the availability of a business energy tax credit could make the crucial difference in a final investment decision for energy efficiency improvements within the corporation;

4) reduced energy costs have the potential to reduce the tax deductions for energy operating expenses as well as generating increased economic activity from industries providing energy efficiency equipment and services. These developments all have positive feedback effects offsetting revenue losses from the energy tax credits themselves;

5) continuation of the business energy tax credit program may in fact be more of an effective revenue enhancement measure than seeking its repeal or permitting its expiration.

We appreciate the opportunity to appear before this Committee and will be pleased to answer any questions you may have.

Cogeneration Coalition, Inc.
1828 L Street, N.W.
Washington, D.C. 20036
Phone (202) 887-5200

Fuel and Power Costs Compared With Pre-Tax Profits

Based largely on the Annual Surveys of Manufactures and a forthcoming volume of revised national income data for 1929 to 1976, here is the cost of purchased fuel and power stated as a proportion of pretax profits;

1978	39.5%
1977	39.9%
1976	37.2%
1975	40.3%
1974	32.9%
1973	24.5%
1972	26.8%
1971	28.6%
1970	31.0%
1969	21.7%
1968	19.0%
1967	19.6%
1966	17.1%
1965	17.5%
1964	20.6%
1963	21.8%
1962	23.7%
1961	25.4%
1960	24.2%
1959	20.9%
1958	25.9%

For types of manufacturing, before and after the 1973 watershed, data limitations require that 1976 be compared with 1967. Here is 1976 energy spending as a proportion of pretax profits.

Primary metals	217.6 %
Glass, brick	113.5 %
Paper	82.8%
Textiles	70.1%
Rubber, plastics	69.1%
Chemicals	62.6%
Food	30.4%
Furniture	27.0%
Wood products	26.6%
Metal products	25.1%
Elec., electronics	21.9%
Clothing	17.3%
Petroleum, coal	16.7%
Miscellaneous	15.2%
Nonelec. mach'ry	14.7%
Motor vehicles	14.3%
Leather	14.2%
Instruments	11.9%
Publications	10.6%
Cigarettes	4.0%

Eleven years earlier (the needed 1966 breakouts aren't available), the same ratios looked like this:

Primary metals	59.0%
Glass, brick	76.6%
Paper	45.1%
Textiles	31.0%
Rubber, plastics	34.5%
Chemicals	37.4%
Food	21.2%
Furniture	14.0%
Wood products	29.4%
Metal products	14.2%
Elec., electronics	9.7%
Clothing	12.5%
Petroleum, coal	11.8%
Miscellaneous	21.9%
Nonelec. mach'ry	8.2%
Motor vehicles	7.2%
Leather	12.4%
Instruments	3.9%
Publications	7.2%
Cigarettes	2.1%

Source: ENERGY USER NEWS
September 14, 1981

Senator **Packwood**. You know the position of both Senator Matsunaga and myself about renewable energy credits and cogeneration credits generally. The thing that always has struck me is in Oregon—which is a heavy timber State—in the early days of the lumber industry, most of the mills were located close to the source. And you tried to cut your timber and mill it. And you were normally in rural areas. And in the early days, most of them used cogeneration. They generated their own electricity from wood slash, and had processed steam because there simply was no electricity where they were. And then they would truck or take out by rail the finished lumber afterward. So it is not a new concept in Oregon. The irony of it is most of those mills left it and went to the centralized use of electricity when we undertook, in many areas, public utility districts. And, in essence, publicly subsidized centrally distributed electricity so they quit cogeneration. But in terms of it being a new concept, it is not at all new at least to the timber industry in Oregon.

Welcome, Sparky. Do you have any opening statement?

Mr. **Matsunaga**. Thank you, Mr. Chairman. And I apologize for the delay. We need three full bodies in this business. We need to be in three places all at the same time. But I will look over your written statements. After a while, I need to go to the Building Commission to meet.

Senator **Packwood**. You mean the Building Commission like the Hart Building?

Senator **Matsunaga**. That's correct.

Senator **Packwood**. Are you on that? I got off of that when they were going to build last spring.

Senator **Matsunaga**. I am wholly in agreement with you in looking over your summary statement, Mr. Zimmer.

Mr. **Zimmer**. Thank you, Senator Matsunaga.

Senator **Matsunaga**. What I would like to know is what effect, if any, the announcement by the President last September when he said that he was going to ask the Congress to repeal the energy tax credit. What effect did it have on your industry or the industries which you represent?

Mr. **Zimmer**. The effect of that announcement was in several areas I would suggest, Senator. It can be summed up initially in one word—uncertainty in terms of making these types of decisions was a paramount concern. Second, I suggest that it may have also, because of that uncertainty, postponed this decisionmaking process for a number of companies that are considering these types of investments; their development was as well as perhaps other renewable energy resource investments. Coupled as well with the continuation of a number of these same problems that I had alluded to earlier because of the failure to implement this tax credit program.

An article recently appeared on this subject at the end of December in the Energy User News. I would quote from that article because I think it's a good summary of just what we are talking about here.

> The failure to conduct this implementation has affected the definitions of exactly what equipment would qualify for the credits. As a practical matter this means that business energy managers can't know exactly what equipment will qualify for the

tax incentives. . . . IRS regulations determine how the agency interprets the law. Furthermore, this lack of clarifying regulations means that some energy managers will lack confidence in the credits, and, therefore, may not use them.

Senator **Matsunaga**. Senators—I think 62 in number—when they cosponsored a resolution expressing the sense of the Senate that energy tax credits should be continued and the Senate stood for the continuation of the energy tax credit—did this, in any way, have a reassuring effect on the industry?

Mr. **Zimmer**. The action undertaken by the Senate that you are referring to did have some degree of a stabilizing effect, I think, on the industry—more so, in the other renewable energy resource areas than perhaps in the cogeneration area because their credits have a longer life span under current statutory provisions as you know, Senator. The cogeneration industry and industrial users' interest in availing themselves of these credits face a shorter time fuse, scheduled to expire the last day of this year. But that action was one that was necessary and one that key elements of the industry joined together to work in support for—and one that was most welcome in terms of sending a balancing signal to offset, to some degree, some of the concerns that evolved with the September announcement by the administration or business energy tax credits.

Senator **Matsunaga**. If I were to make any opening statement, Mr. Chairman, it is that you can depend upon this Senator and I am sure, Mr. Chairman, that we will do all in our power to continue the energy tax credit because we feel that the development of alternative energy is the one way we can find independence from the OPEC cartel, and that we can begin to have a surplus in our balance of trade. It is only when we begin to buy less foreign oil for energy needs that we are going to be able to balance even our domestic budget, because we are paying much too much for foreign oil at this point.

Thank you very much.

STATEMENT OF BARRY B. DIRENFELD, EXECUTIVE COMMITTEE MEMBER, RENEWABLE FUELS ASSOCIATION, WASHINGTON, D.C.

Senator **Packwood**. Mr. Direnfeld, substituting for Mr. Hallberg.

Mr. **Direnfeld**. On behalf of the Renewable Fuels Association of which I am an executive director, we appreciate the opportunity to testify. And, of course, are very much appreciative of the support of the chairman and Senator Matsunaga.

I am also, in addition to being an executive director of the association, president of the New Energy Corp. of Indiana. And so I think to the extent you could ask questions that would relate to our own case study of one who is out there developing an alcohol fuels project, I would be happy to answer those as well.

Other members of the executive committee of the association are Texaco, Archer, Daniels, Midland, American Gasohol Refiners, South Point Ethnol, E. F. Hutton, Publicker Industries Inc., and A. E. Staley.

Senator **Packwood**. I didn't quite get what your company is.

Mr. **Direnfeld**. New Energy Corp. of Indiana. It's one of the recipients of a conditional commitment for a loan guarantee under the Department of Energy program.

Senator **Packwood**. Is it a relatively new company?

Mr. **Direnfeld**. It's a startup company that is 2 years old. I believe it can provide relevant insights into Senator Matsunaga's question regarding the impact of the administration's September announcement. Our company is scheduled to go into the marketplace with E. F. Hutton and First Boston Corp.—two of Wall Street's most prestigious investment banking houses—for the first public equity offering under the alcohol fuels program. We, of course, will file a registration statement with the Securities Exchange Commission which discloses all the risks inherent in the offering. Of course, this will highlight the risks inherent with a new industry such as startup, technology, et cetera. But beyond that, the additional risk that will now be disclosed is that there is pending legislation before Congress which affects the availability of the tax credits. To the extent that this remains in effect, notwithstanding a congressional resolution and notwithstanding your strong letters of support, it hangs as a cloud over the entire industry's viability. The only thing that we can suggest is that fast action be taken to dispense finally with this issue. And, of course, I am speaking now for E. F. Hutton and First Boston as well as members of the Renewable Fuels Association.

Mr. Chairman, the investment community is, in my judgment, ready to make a breakthrough in terms of financing alternative energy sources. It is significant that two of the more prestigious conservative investment bankers have decided to undertake our offering as a test case. But, again, much of it hinges upon your actions here in disposing of this matter in a very definitive and expeditious way.

The Renewable Fuels Association at this moment primarily consists of alcohol fuel producers. We are totally opposed to the entire proposal sent up to repeal the energy tax credit. Since a majority of the committee has already signaled their opposition to it, I think it will be useful to walk through some of the arguments that the administration put forward in supporting them. And then briefly talk about the impacts.

The administration's arguments are basically that the free market allocation of resources ought to prevail. And, therefore, with the decontrol of oil prices, these credits are no longer necessary. A book that was published several weeks ago by the Georgetown University Strategic and International Center, one of the country's more prestigious of foreign policy groups. The foreword was written by former Secretary of State Henry Kissinger. The Kissinger foreword and book's preface states:

> That the energy crisis has, in fact, placed at risk all of the Nation's objectives in the world. It has mortgaged our economy, made our foreign policy vulnerable to unprecedented pressures, weakened the industrial democracies economically, and undermined political unity that is basic to the security of all free nations. It has curtailed world economic growth, frustrated the hopes for progress in developing in the world. And it has profoundly effected our national security by triggering a political crisis of global dimension. The industrial democracies must adopt stringent conservation measures, develop new supplies of oil and alternative sources of energy and seek a more reliable long-term relationship with its producers. I want to point out the disastrous international consequences of continuing vulnerability and urge the problem be dealt with with the highest urgency. Aside from our military defense, there is not project more essential to the importance of national security.

The book goes on to discuss that even in light of the current oil glut, there is no reason for us to be sanguine about our long-term dependency and urged very strongly that we continue to develop projects in the alternative area.

In alcohol fuels, many projects take over 2 years to construct. We are not looking at an oil market at this moment, we are looking at what it might look like in 1985, in the latter part of the decade. To commit the millions of dollars necessary to accomplish this, a high degree of certainty is needed. Congress has provided the certainty by extending the alcohol fuel tax credit for construction through 1985, and the operating subsidies through 1992. This permits an investor, as well as an investment banker, to analyze what the economic implications of the project would be on a long-term, not a short-term, basis. It will get us out of the short-term crisis-to-crisis type of planning.

The administration goes on to suggest that transition rules provided in their proposal will, in fact, permit companies who have already made investments to go forward and not have an adverse impact. In fact, the congressional research service had just recently completed a study which says:

> Without the four cent gasohol tax advantage, alcohol fuels as an energy alternative would be totally destroyed. Even a serious discussion of repeal of tax advantage would have a strong adverse consequence for the alcohol fuels industry, because the prospect of loss of this advantage will discourage investment in alcohol fuel plant construction.

Beyond that, Senator, many companies have in good faith, based upon what the Congress has done in the past, invested millions of dollars. My company, a small startup company, has invested over $3½ million to date to plan our project. These expenditures were based upon the existence of the subsidies as they were passed by the Congress. Other members of the Renewable Fuels Association have made similar expenditures. Texaco has already constructed a $60 million gallon facility. Archer, Daniels, Midland has constructed even larger facilities. These multimillion dollar investments will be worthless without the tax credits.

We again thank you for the opportunity to testify and to register our position and try and provide you with some insight as to the need for them.

[The prepared statement follows:]

STATEMENT OF DAVID E. HALLBERG, PRESIDENT, THE RENEWABLE FUELS ASSOCIATION

Thank you, Mr. Chairman. On behalf of the membership of the Renewable Fuels Association and the industry it represents, I would like to commend you and your Committee for affording the Nation's alternative energy industry this opportunity to make known its emphatic opposition to the Administration's proposal to repeal the business energy tax credits.

The Renewable Fuels Association has as its objective the near-term commercialization of a wide range of renewable technologies. Recently, as reflected by its membership, the "cutting edge" of the Association's efforts have been in the area of fuel alcohol production and use.

As such, the Association strongly opposes the Administration's specific initiatives with respect to alcohol fuel as set forth in the Treasury Department's February 26, 1982 elaboration of its proposed tax revisions. The Association's opposition to these initiatives is total, and includes unqualified opposition to the so-called "transition rules" designed to "protect" projects holding binding contracts. We are convinced that the facts clearly demonstrate this proposal to be ill-advised, and that its enactment would have ramifications that run counter to the Nation's budgetary, economic, and energy security goals. The business energy tax credits are not "unnecessary and obsolete" as maintained by the Treasury Department. In fact, they are an important investment in our nation's energy future.

The alcohol fuels industry joins with the rest of the alternative energy community in thanking the farsighted members of this Committee, including its courageous Chairman, for their clear and oft-repeated statements of support for the retention of the business energy tax credits (Attachment A). In recognition of the fact that a solid majority of the Committee has already gone on record in recent weeks in opposition to the proposal to repeal the business energy tax credits, I would like to focus on the primary elements of the Administration's rationale in support of its proposal.

I. "CRUDE OIL DECONTROL HAS ELIMINATED THE NEED FOR THE BUSINESS ENERGY TAX CREDITS."

This argument does not withstand scrutiny. While the decontrol of crude oil prices was a necessary step toward improving the ability of the various energy alternatives to compete with traditional energy forms, it is dangerously simplistic to base an energy policy on the premise that decontrol alone is sufficient to bring about the allocation of capital resources needed to stimulate alternative energy commercialization in a timely and orderly way. The Administration's position is predicated on its contention that energy decisions are made just like any other investment decision, simply on the basis of the operation of "market forces" and relatively unmanipulated supply and demand stimuli.

Nothing could be further from the truth. As the attached Wall Street Journal article indicates (Attachment B), Saudi Arabian decisions to consciously overproduce during 1981 stemmed in large part from its policymakers' perception that the Western world's progress toward commercializing alternative energy technologies had picked up too much steam. The unfortunate upshot of this ability of foreign oil producers to "fine tune" their production rates at will, thereby creating falling real or even nominal prices, is that the financial community is understandably reticent about committing the huge sums of money necessary to commercialize energy alternatives without incentives like those offered by the business energy tax credits. In short, as this Committee's Chairman, Senator Bob Dole pointed out in a speech at an ethanol plant groundbreaking on January 30 of this year: "Even the market is not always a perfect laboratory in which to test and refine a new product. Free enterprise isn't always free." (Attachment C)

Retention of the tax credits for alternative energy technologies is justified as one particularly effective means of continuing the needed "partnership of the public and private sectors" that must exist if the Nation is to end its dangerous dependence on foreign oil. Energy is inarguably a unique commodity. This is largely due to the extreme volatility of world oil markets, as well as the political instability of most of the major oil producing nations, especially those in the Persian Gulf. While the recent months have seen the pendulum swing to lower gasoline prices due to a temporary oversupply situation, Attachment D underlines the fact that uncertainty is, if anything, increased, and the failure of oil importing countries to take advantage of the current respite from oil supply interruption and escalating prices by increasing their own indigenous production capabilities could very well prove to be even more disastrous the next time around.

One final rebuttal to the Administration's first rationale is that forcing alternatives to "compete in the marketplace" ignores the fact that the true costs of conventional fuels are generally undervalued as a result of their own hidden incentives and support. Attachment E is a short analysis of a recent Institute of Gas Technology paper which attempted to identify the true costs of a barrel of imported crude. Inarguably, if liquid fuel alternatives are to be made to "compete in the marketplace" with conventional, petroleum-based fuels, equity demands that all costs associated with those fuels' production, transportation, and marketing be attributed. As the IGT analysis points out, there are a great many costs associated with a barrel of foreign crude which are not reflected in its price. Failure to take these costs into account means that alternatives are being forced to compete in the marketplace against an artificially undervalued product. Especially when viewed in terms of costs to the nation as a whole (e.g., the national security, job creation, and inflationary premiums), a barrel of imported crude oil may in fact cost a factor of two to three times more than its actual "posted price" against which relative cost comparisons for alternatives are drawn up.

II. "THE BUSINESS ENERGY TAX CREDITS ARE UNNECESSARY AS A RESULT OF PASSAGE OF THE ACCELERATED COST RECOVERY SYSTEM (ACRS)".

Once again, the above rationale used by the Administration reflects a glaring misunderstanding of the needs of alternative energy technologies, as well as the realities of the investment marketplace. Attachment F is a brief comparison of how a typical alcohol fuel facility would fare under pre-1981 tax law as opposed to a combination of ACRS and a repeal of the energy investment tax credits (EITC). Obviously, even under the most favorable of assumptions for the ACRS approach, the application of ACRS plus repeal of the EITC would reduce the total tax benefits available to most property in an alcohol fuels facility by at least fifteen cents per each dollar of investment.

Such a reduction is significant in and of itself, but the loss of the credits would be even more damaging to alternative energy investments. For alternative energy projects (which are perceived as having extremely high risk in part due to the unparallelled volatility of today's world oil market) to be able to attract the needed capital, it is imperative that potential investors be offered a potential premium in their rate of return. Given roughly the same rate of return for investment in either a supermarket, for instance, or in an alcohol fuels facility, it is almost certain that a typical investor will opt to put his money into the supermarket, since its risk penalty is a great deal lower. While this may be the decision that optimizes the returns for the individual investor, it is most certainly not the optimum course of action for the country as a whole. The nation's energy consumers and taxpayers alike are cheated by such a policy, since the opportunity is lost to reduce the costly "export" of billions of dollars each year to pay for foreign oil, as well as our vulnerability to further inflation, loss of jobs, and eroded federal and state tax bases.

Finally, this particular rationale is especially hollow for the alcohol fuels industry, since the Administration would also repeal the per gallon incentives provided by the crucial 4¢ exemption from the federal excise tax on gasoline. Unfortunately, there exists irrefutable proof that alcohol fuel project sponsors and investors see the retention of the business energy tax credits, and especially the 4¢ exemption, as crucial. Attachment G is a copy of the recent Wall Street Journal article noting the decision by the 75 percent partner of Minnesota Alcohol Producers, The Minnesota Gas Co., to withdraw from the project as a result of the threat to the credits. The remaining partners are now searching for a replacement for Minnegasco in order to allow this very strong project to continue its final negotiations for a DOE loan guarantee, but it will be difficult to make the needed adjustments in the time allotted. It would be a particular waste if the Treasury's threat to repeal the credits results in the loss of this project, which could have made such a significant contribution to the state of Minnesota's economy and tax base. Minnesota's senator on this Committee, Senator David Durenberger, should be especially commended for his leadership in the effort to retain these needed credits, and thereby to stimulate the needed investment in domestic energy production capability.

III. THE BUSINESS ENERGY TAX INCENTIVES "DISTORT THE ALLOCATION OF RESOURCES", AND "DIVERT WORKERS, CAPITAL, AND INITIATIVES FROM MORE PRODUCTIVE USES".

It is hard to conceive of a more inaccurate statement. The March 15, 1982 cover story in Forbes entitled "The Great Oil Swindle" offers one of the best rebuttals to this rationale. Quoting Herbert W. Krupp, Bankers Trust energy economist: "The enormous [oil] price hikes in 1973-74 and 1979-80 drained consumer purchasing power in the United States, disrupted international trade, provoked economic distortions and accelerated inflation." The article's author, James Cook, noted that "the oil shocks of 1973 and 1979 did more than multiply the price. They dampened down the economic growth of the entire Western World." Compared to an annual growth rate of 5% between 1965 and 1972, world real GNP rose only 3.8% between 1973 and 1978, and 2.6% from 1979 to 1981. Not only does this specter of continued low economic growth rates carry with it serious implications for the stability of governments in both the developed and developing world, but it does not even begin to fully quantify the costs associated with destabilizing world oil markets for the U.S. in terms of the threats to our national security and geopolitical interests. Because of our dependence on Middle East oil sources, for instance, we are now planning to spend tens of billions of dollars for a Rapid Deployment Force to "keep the oil lines open", and incurring the wrath of our European allies in our efforts to have them suspend the construction of the Soviets' Siberian natural gas pipeline. The consideration of how this country can best maintain stable and reasonably priced supplies of foreign oil has permeated not only every major economic decision, but also nearly every major foreign and defense policy decision, as well.

In this light, then, it is difficult to understand the basis for the Treasury's rationale that energy tax credits "distort" the allocation of resources. Only the most short-sighted view of the economic relationship between U.S. foreign oil dependence, with its periodic supply interruptions and consequent price "spikes", and the serious economic difficulties in which we now find ourselves could lead one to conclude that it is not the best investment this country can make to catalyze substantial investment in domestic energy alternatives. Attachment H is a copy of the conclusions of a recent Department of Energy Office of Alcohol Fuels report which considered the economic activity and tax revenue impacts of a theoretical 50 million gallon per year alcohol fuel facility on both states and the federal government. The study unequivocally concluded that the net result of the 4¢ excise tax exemption was to stimulate significantly increased federal tax revenues. These figures would seem to suggest that, in this instance at least, there is indeed such a thing as a "free lunch".

IV. "THE PROPOSAL WILL AFFECT PRIMARILY INVESTMENT IN UNCONVENTIONAL TECHNOLOGIES", AND ... "DOES NOT AFFECT MANY POST-1982 INVESTMENTS IN ALTERNATIVE ENERGY PROPERTY".

This statement is confusing, misleading, and once again reflects a disturbing failure on the part of Treasury to understand the status of the various alternative energy technologies that it would affect by the proposal. In the case of the alcohol fuels industry, for example, use of the term "unconventional technologies" is particularly confusing. If that term is to mean technologies that are far in the future in terms of commercial relevance, than it could not be more inaccurate. In fact, the alcohol fuels industry can make a claim that no other energy alternative can: it is the only high grade liquid fuel alternative now being produced and used in significant quantities on a commercial scale. With the addition of several new production facilities, and improved production processes, more sophisticated marketing practices, and heightened competition within the industry, sales of alcohol for fuel increased 25% in 1981 over 1980, despite the decline in gasoline consumption for the second straight year, falling gasoline prices, and destabilizing reversals in federal government policy. Impressive strides are being made in the area of improved production technologies, including the use of cellulosic feedstocks for conversion into alcohol, and the visions of the industry's early supporters, such as the Chairman of this Committee, are being realized.

The development of any new industry, however, and especially one that finds itself attempting to penetrate the established energy marketplace, cannot happen overnight. In promising the alcohol fuels industry the 4¢ excise tax exemption until 1992 in the Crude Oil Windfall Profits Tax Act, the Congress realized the importance of allowing sufficient lead time and stability if the needed private sector participation was to be encouraged in the face of the considerable risks. Similarly, the use of alcohol as an octane enhancer at the refinery level also offers the Nation considerable advantages in terms of improved engine performance, reduced crude loss at the refinery, and reduced health and environmental hazards relative to other alternatives, but the blender tax credit provided by the 96th Congress must be retained for its duration if the necessary private investment is to occur.

The fact that the alcohol fuels industry has in only a few short years demonstrated its dependability, feasibility, economic value, and compatibility is important not only from the perspective of the significant economic benefits it can provide, but also the very real national security potential it offers to a Nation still dangerously dependent on unstable foreign governments for several million barrels per day of its oil. In the event of a major interruption, the alcohol fuels industry stands alone in its ability to quickly bring on-line significant quantities of high-grade liquid fuel, and would be extremely valuable in terms of ensuring that the Nation's agricultural sector would have the fuel it needed to meet national food and fiber requirements. The industry is in fact one of the cheapest "insurance policies" we as a nation could have, and Senator Dole said it best in his January 30 speech when he stated that "...it would be almost tragically short-sighted to cut off incentives to an industry still developing, still evolving in its promise to America."

V. "ALCOHOL FUEL PRODUCTION FROM EXISTING PLANTS IS LIKELY TO BE DECREASED ONLY SLIGHTLY BY THE PROPOSED PHASE OUT OF THE ALCOHOL FUEL TAX INCENTIVES."

This statement is one more instance of Treasury misperception of the alcohol fuels industry, and of the ramifications of its proposal on it. Attachment I is a copy of excerpts from a recent CRS study of the likely impacts of the proposed repeal of the credits on the alcohol fuels industry. In every case, whether it be existing producers with a total of hundreds of millions of gallons of production capacity on line, or prospective producers who have already risked hundreds of thousands of dollars in preparing their project, the answer is the same: the repeal of the credits will mean the death of the entire industry.

One other problem that has dogged the entire alternative energy community, but especially the alcohol fuels industry, is the consistently inflated revenue loss estimates attributed to the repeal of these credits. Attachment J is a copy of a letter to Treasury Assistant Secretary

Chapoton providing the industry's projections of "out year" revenue effects of the credits. (Once again, it should be stressed that these figures do not take into account the effect of increased federal revenues from the productive investment that results.) In any case, the gains to the Treasury are so miniscule that they are far outweighed by the importance of retaining the credits as a means of stimulating needed alternative energy investments.

VI THE LOSS OF FEDERAL GOVERNMENT CREDIBILITY: A SERIOUS THREAT TO REINDUSTRIALIZATION.

Finally, Mr. Chairman, we firmly believe that the adoption of this proposal to repeal the business energy tax credits would do serious harm to interests that far transcend the more limited concerns of the alternative energy community and the alcohol fuels industry. It is almost certain that adoption of this proposal would send a signal to the business community that the federal government has no qualms about changing course in mid-stream, and that the "rules of the game" are subject to revision at a minute's notice, no matter how fundamental they may be to the successful outcome of a business decision. (In the case of alcohol fuels, Attachment K underlines several of the high level assurances given by this Administration to the continuation of the industry's credits.) Certainly, such a signal would do irreparable harm to this Administration's oft-stated reindustrialization goals, since decisionmakers in every industry would feel vulnerable to such capricious shifts in the future. The willingness of businessmen and investors to take risks would surely diminish, and the Nation's economy would further decline and stagnate.

The membership of the Renewable Fuels Association consists of many firms who have committed literally hundreds of millions of their own dollars to alcohol fuel projects in a good-faith response to the invitation of the Congress and the Federal government. Not only are huge amounts of private funds at risk in these projects as a result of past government assurances, but also hundreds of millions of dollars worth of federal funds in the form of loan guarantee and cooperative commitments spread out over numerous projects that will certainly collapse if the credits are repealed. There can be no question that the rejection of this proposal by your Committee will prevent not only the loss of these projects, and the public and private funds committed to them, but also the loss of something even more valuable: the credibility of the Nation's lawmakers that is vital if the desired business community response is to be elicited. In that very real sense, your decision on this particular proposal will have ramifications that go far beyond individual alternative energy projects, and affect the success of the entire reindustrialization effort.

SUMMARY. In conclusion, Mr. Chairman, on behalf of the Nation's alcohol fuels industry, I would like to once again thank you and the rest of the members of your Committee for this opportunity to present our views in support of the retention of the business energy tax credits, as well as for your past and continuing support for the development of a viable alternative energy industry in this country. We firmly believe that there is overriding proof that the adoption of the Treasury's proposals would incur significant budgetary, economic, energy security, and federal government credibility costs, and that it should be rejected in its entirety. We would also ask that the Committee reject the proposal as quickly and emphatically as possible, so that all uncertainty can be removed in the eyes of the financial community, and we can continue the effort of reducing U.S. dependence on unstable foreign oil supplies. Thank you very much.

News from Senator

ATTACHMENT A·

BOB DOLE

(R - Kansas) 2213 Dirksen Building, Washington, D.C. 20510

FOR IMMEDIATE RELEASE:
FRIDAY, JANUARY 29, 1982

CONTACT: CATHY PILLION
(202) 224-6521

DOLE SEES LITTLE LIKELIHOOD OF REPEAL OF ENERGY TAX CREDITS

TOPEKA, KANSAS -- Senator Bob Dole (R.-Kan.), Chairman of the Senate Finance Committee, today predicted that there is little likelihood that the business energy tax credits will be repealed as recommended by the Treasury Department.

"The Congress has already gone on record in a sense of the Congress resolution that it opposes any cutback in energy tax credits," Dole stated. "There is considerable concern that repeal of the business tax incentives would doom the infant renewable fuels industry, an industry which has developed largely with the help of the energy tax incentives. It would be unfair and unwise to pull the rug out from under this industry before it has had a chance to achieve economic self-sufficiency.

"If we make the investment now, I am convinced that over the long run renewable fuels will play a vital role in America's energy independence," said Dole.

ATTACHMENT A.2

[illegible]

United States Senate
COMMITTEE ON FINANCE
WASHINGTON, D.C. 20510

February 9, 1982

The President
The White House
Washington, D.C. 20500

Dear Mr. President:

Last fall, in your September 24th budget address, you proposed to repeal certain business energy tax credits as a means of enhancing revenues. In response, 62 Senators (including a majority of this Committee) and 266 Congressmen signed a resolution of disapproval which was ultimately incorporated into the FY 1982 Continuing Resolution.

We are extremely disappointed that your budget proposal again seeks to eliminate the business energy tax credits. The repeal of these credits and exemptions for the various alternative energy technologies would be, in our estimation, an extremely shortsighted action exacerbating the nation's continuing dependence on expensive, unstable supplies of foreign oil. Clearly, the decontrol of oil, while a positive step, is not itself sufficient to encourage alternative energy investment necessary to reduce our dependence in a timely fashion.

Mr. President, thousands of individuals and businesses have responded to the tax incentives and to your own Administration's assurances as to their retention. They have taken considerable risks and spent hundreds of millions of dollars in an attempt to commercialize alternative energy technologies. Their investment in alternative energy production will contribute to the Nation's anti-inflation, employment, reindustrialization, and energy security goals.

As members of the Committee of jurisdiction, we are writing to inform you of our emphatic opposition to your proposal, and our determination to preserve a stable investment climate for a domestic alternative energy industry. We look forward to working with you to achieve our common objectives.

Respectfully,

Malcolm Wallop

Dave Durenberger

Russell Long
John Chafee

Spark M. Matsunaga
Steve Symms

John Heinz
Bob Packwood

Max Baucus
David Boren

Moynihan

ATTACHMENT A.3

United States Senate
COMMITTEE ON FINANCE
WASHINGTON, D.C. 20510

February 12, 1982

The President
The White House
Washington, D.C. 20500

Dear Mr. President:

Last fall, in your September 24th budget address, you proposed to repeal certain business energy tax credits as a means of enhancing revenues. In response, 62 Senators, including a majority of the Senate Finance Committee, and 266 Congressmen signed a resolution of disapproval which was ultimately incorporated into the FY 1982 Continuing Resolution.

I am extremely disappointed that your budget proposal again seeks to eliminate the business energy tax credits. The repeal of these credits and exemptions for the various alternative energy technologies would be, in my estimation, an extremely shortsighted action exacerbating the nation's continuing dependence on expensive, unstable supplies of foreign oil. Clearly, the decontrol of oil is not itself sufficient to encourage alternative energy investment necessary to reduce our dependence in a timely fashion.

Mr. President, thousands of individuals and businesses have responded to the tax incentives and to your own Administration's assurances as to their retention. They have taken considerable risks and spent hundreds of millions of dollars in an attempt to commercialize alternative energy technologies. Their investment in alternative energy production will contribute to the Nation's anti-inflation, employment, reindustrialization, and energy security goals.

As a member of the Finance Committee, I am strongly opposed to your proposal. I believe that the development of alternative energy supplies deserves substantially more support than your energy policy has provided.

Sincerely,

George J. Mitchell
United States Senator

ATTACHMENT A.4

WILLIAM L. ARMSTRONG
COLORADO

United States Senate
WASHINGTON, D.C. 20510

February 25, 1982

The Honorable Donald T. Regan
Secretary of the Treasury
Washington, D.C. 20220

Dear Mr. Secretary:

I am writing to express my opposition to the elimination of the business energy tax incentives as proposed by the Administration. This government policy of tax incentives has generated a substantial investment in the development of alternative energy technologies throughout the U.S.

It is my view that the federal government should not undercut those who, in good faith, have invested in new and emerging technologies by an abrupt policy change. The development of alternative domestic energy sources is a long-term process that depends on a consistent tax policy upon which investors can rely.

Best regards.

Sincerely,

William L. Armstrong

WLA:hpe

Renewable FUELS

Renewable Fuels Association
499 S. Capitol Street, Suite 490
Washington, D.C. 20003
(202) 484-9320

David E. Hallberg
President/Chief Executive Officer

ATTACHMENT B

THE WALL STREET JOURNAL
APRIL 13, 1981 Page 21

OPEC Members Expressing Doubts About Wisdom of Raising Oil Prices

By Youssef M. Ibrahim

Staff Reporter of The Wall Street Journal

ROME—For the first time in years, the Organization of Petroleum Exporting Countries seems genuinely worried that it has pushed oil prices too far too fast.

This sentiment came through loud and clear last week in a gathering here of important Arab oil officials and their counterparts in several southern European nations. At a conference on economic cooperation between oil producers and consumers, one OPEC official after another hinted that the time may have come to slow down the drive for higher and higher oil prices.

The OPEC leaders' reasons vary, but they all boil down to a startling realization: The fast-rising price of OPEC oil—a 20-fold increase over the past decade—has forced major consuming nations to look for alternatives at a much faster pace than OPEC would like. As a result, demand for OPEC oil is dropping too fast; the same could happen soon to OPEC revenues.

Reducing OPEC's Share

"Substantially higher prices in real terms in the future will no doubt accelerate the pace of transition, and hence speedily reduce OPEC's share of total energy requirements," warns Fadhil al-Chalabi, Iraqi deputy secretary general of OPEC.

His central argument: The industrialized countries can move much faster toward finding alternative sources of fuel than OPEC members can move toward diversifying away from total dependence on oil.

The surprise was that his audience of oil ministers and senior oil executives was more than ready to hear him out. The oil ministers of Kuwait, Libya, Iraq and Algeria echoed his view to varying degrees in interviews and speeches. Saudi Arabia has been making such an argument for some time.

Further indications of the mood at OPEC should surface at its May 25 meeting in Geneva. The new attitude is likely to prevent a price increase and to produce an attempt to narrow the spread between the minimum and maximum prices charged by the member nations.

The OPEC oil ministers have ample reason for concern. World demand for oil from the 13 OPEC members is projected to be less than 12 million barrels a day by the end of the century—less than half the amount they are expected to be able to export this year. Gone are the forecasts of OPEC exports in the range of 40 million barrels a day, estimates that many experts were mentioning just a few years ago for the year 2000.

One reason is that consumers are buying more oil from non-OPEC nations such as Mexico, Malaysia, Norway, Canada and Angola. In 1979, the non-Communist nations consumed 52 million barrels of oil a day, of which 31.6 million barrels came from OPEC. This year, consumption will average 48 million barrels a day, with no more than 25 million from OPEC, according to the estimate of the International Energy Agency.

"The price of oil is by far the largest single factor in the conversion," says Wallace Hopkins, deputy director of the Paris-based agency, which includes Japan and major industrialized nations of the West. That oil price now averages about $36 a barrel.

> *"If we force the West to invest heavily in finding alternative sources of energy, they will," Sheik Yamani, the Saudi oil minister, has said. This could reduce the nations' dependence on oil "to a point that will jeopardize Saudi Arabia's interests."*

Among the profound changes the price rises have wrought is what Mr. Hopkins describes as "a different psychological appreciation among consumers that there is indeed an energy crisis." People are driving less, using less electricity and generally conserving all fuels.

Utilities around the world are substituting more coal and natural gas for oil. Japan's entire cement industry has switched from oil to coal for power generation. In the U.S., a new generation of smaller, more fuel-efficient cars is coming. And simple investments in better insulation for houses and commercial buildings have been made on a global scale. Many homes also are switching from oil to gas for heat.

The result has been a sharp drop in oil consumption throughout the industrialized world. According to the International Energy Agency, oil demand fell 8% in 1980 from 1979, and it is likely to drop another 4% to 6% this year.

Moderation for Survival

Seeing the link between steep price rises and demand, Saudi Arabia has been arguing for more than two years that moderation in pricing is essential to OPEC's long-term survival. Sheik Ahmed Zaki Yamani, the Saudi oil minister, made this point explicitly in a speech at the University of Petroleum and Minerals in Saudi Arabia a few months ago.

"If we force the West to invest heavily in finding alternative sources of energy, they will," he said. "This would take no more than seven years and would result in reducing (the West's) dependence on oil as a source of energy to a point that will jeopardize Saudi Arabia's interests."

Last week's conference provided the first indication that a large group of OPEC producers are taking this line of reasoning seriously. Kuwait's oil minister, Ali al Khalifa al-Sabah, who has been in a unique position as a bridge between OPEC hard-liners and moderates, indicates the time has come for holding prices down.

A Price Freeze?

"If you increase the price dramatically over a short period, demand for OPEC oil will drop. That is what happened over the past two years," he says. He predicts a price freeze through 1981.

The same message comes from the oil minister of Iraq, Tayeh Abdul Kerim. Even Libya, which has been in the forefront of the drive for higher prices, agrees that it was time to stop. "If it is agreeable with other producers, we will freeze our prices," says Abdul Salaam al-Zagaar, Libya's chief oil official.

Some OPEC producers, such as Algeria and Libya, believe that if Saudi Arabia would cut its oil production from the current 10.3 million barrels a day to the official Saudi production ceiling, 8.5 million barrels, the erosion of demand would end. But there are clear indications that most OPEC members now lean to the view that it isn't in their interest to put undue pressure on the West to find alternatives to oil.

Renewable
FUELS

Renewable Fuels Association
499 S. Capitol Street, Suite 420
Washington, D.C. 20003
(202) 484-9320

David L. Hallberg
President/Chief Executive Officer

ATTACHMENT C

EXCERPT FROM SENATOR DOLE'S SPEECH AT THE ETHANOL PLANT GROUND BREAKING
COLWICH, KANSAS JANUARY 30, 1982

". . . You cannot go it alone. Even the market is not always a perfect laboratory in which to test and refine a new product. Free enterprise isn't entirely free.

I have long advocated a partnership of the public and private sectors in providing a stable economic climate within which to realize the maximum potential of ethanol. The 4¢ per gallon excise tax exemption has served this purpose well. In part because of this and other incentives contained in the 1980 windfall profits legislation, alcohol fuel has grown from an industry dominated by a single firm to a much broader base. Today, producers range from prototype plants turning out two or three million gallons a year, to giants capable of manufacturing up to sixty million gallons.

But it's the excise tax exemption that remains the linchpin of our efforts to promote private development of alcohol fuels in this country. None of these incentives have been achieved easily. They've involved much debate and considerable persuasion. But in the end, the immediate availability of ethanol fuel and the continuing need to reduce import levels have overcome opposition arguments.

Now, the industry faces another battle. A battle to retain the key to the industries' growth and success. But, I believe we will win. There was little support for repeal of the four cent exemption last September and there is little now. For my part, I intend to quickly move in the Finance Committee to defeat this proposal and remove the cloud from an otherwise bright future.

I continue to support the program - and to be encouraged when I see major new investments like this one. Even in a time of recognized austerity, I think it would be almost tragically short sighted to cut off incentives to an industry still developing, still evolving in its promise to America."

Renewable Fuels

Renewable Fuels Association
499 S. Capitol Street, Suite 420
Washington, D.C. 20003
(202) 484-9320

David E. Hallberg
President/Chief Executive Officer

ATTACHMENT D

WALL STREET JOURNAL.
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MONDAY, MARCH 8, 1982

Sinking Feeling

Latest Oil Uncertainty Concerns Drop in Price Rather Than Big Rise

Worries Increase Over Slump In the World's Economy; Effect of Saudis' Action

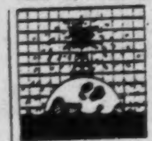
New Hope for Gas Guzzlers

By YOUSSEF M. IBRAHIM
Staff Reporter of THE WALL STREET JOURNAL

The world's oil markets are on a knife-edge.

Demand is shrinking, and prices are falling rapidly. Oil-exporting nations are undercutting one another's prices in frantic efforts to increase sales. Oil buyers are rushing to get out of contracts. Oil-company profits are drying up. Planners in practically every country and in hundreds of thousands of companies are wondering where the price of oil is heading next.

"Take a coin, flip it in the air and see which way it's going. Things are changing from one week to another," says Charles Maxwell of Cyrus J. Lawrence Inc., one of Wall Street's most prominent energy analysts.



That uncertainty was only increased Saturday when Saudi Arabia announced that it is cutting its oil production by a million barrels a day, to a new ceiling of 7.5 million barrels a day. (For details, see story on page 3.) Many experts believe that because of the current oversupply of crude oil, a much sharper cut—say, two million barrels a day or even more—would be required to stabilize prices.

Others, however, feel that the "psychological impact" of the announcement may go beyond its physical impact because of Saudi Arabia's pivotal role as the world's largest exporter of crude. Whichever view proves to be correct, a thoroughly confused market that is unable to make an accurate assessment of long-range demand for oil will need time to take measure of the effect.

This is the first of a series of occasional articles on ramifications of the oil glut.

Oil has always been a business of ups and downs. But rarely has it been subjected to such pressures and confusion. In the past two decades, the political upheavals of the Middle East, where the bulk of the world's oil reserves lie, have interrupted supplies four times, making the politics of oil as important as its economics. The current downward pressures on prices have been welcomed by many observers. They see the oil industry as being finally subjected to the laws of supply and demand, and they applaud the decline in prices.

Problems With a Decline

Yet, however welcome, the sliding prices are causing many problems, at a time when the stakes have grown almost beyond calculation. When, in 1972, oil cost only $2 a barrel, price fluctuations of a few cents up or down didn't matter very much. Now at an official average of $34 a barrel, fluctuations in oil prices can make or break economic plans, enrich or impoverish nations, depress or revive the world economy—and spark social upheavals.

Most oil analysts believe that over the next few years oil prices are headed down. The questions that they debate are these: How far will prices plunge? Are prices out of control? And—most important—will they eventually shake the world's economies by suddenly leaping back up because of political earthquakes in major producing countries or a yet unaccounted for leap in demand for oil?

Walter Levy, the international oil consultant, sees a striking—and unsettling—paradox. "The rise in oil prices brought a recession; the fall may be even more upsetting to the world economy," he says. "The unpredictability of it all adds to the instability as people make decisions in the dark. A fall in the oil price is good if it happens gradually. But suddenly arrived at, it could be devastating."

A plunge in oil prices could be devastating—and not just because it would wreak havoc with governments' policies and revenues and with companies' investment plans. It also is stirring up severe tension within the Organization of Petroleum Exporting Countries. Although people in the Western nations may be tempted to gloat over disputes among the OPEC nations—which they consider rich and greedy—the tension can well be seen as a worrisome threat to Saudi Arabia.

Pressure on Saudis

For months, Saudi Arabia has been pressured by other OPEC producers to stop flooding the already-glutted market with more oil than the market can absorb. Both Iran and Libya have openly threatened the Saudis. Iran has hinted that it can easily raid Saudi oil facilities and shut them down. Last week, Libya loudly renewed its call for the overthrow of the strongly pro-Western Saudi monarchy. Even Saudi Arabia's conservative friends, such as Kuwait and the United Arab Emirates, have brought pressure to bear on the Saudis for lower production. This concerted action clearly played a great role in the Saudi decision Saturday to lower its official production ceiling.

Because of their small population and thus their limited need for oil revenues, the Saudis can strongly influence the oil markets. They can swing their oil output all the way up to 10 million or 11 million barrels a day and bring it down to the current level or lower. But the Saudis don't know exactly how far to cut back to dry up the current glut. Thus, a Saudi miscalculation could

Please Turn to Page 22, Column 1

Sinking Feeling: Oil Uncertainty Now Concerns Drop In Price That Could Seriously Hurt World Economy

Continued From First Page

trigger another shortage that would send oil prices soaring again and push the world economy—including Saudi Arabia's—into depression.

"We have a very strange and volatile market here," says James R. Schlesinger, a former Secretary of Energy and Secretary of Defense and once the director of the Central Intelligence Agency. "It may take a real low level of Saudi production to recapture their dominance of the international market. We are looking to see whether they have enough control to prevent the collapse of the oil markets." He adds hopefully, "I suspect they can do it."

Nonetheless, the days of administered oil pricing may be fading. From the end of the World War I through the high-growth era of the 1960s, the giant oil companies owned the major oil concessions and held a firm rein on prices. But in the 1970s, that control slipped to OPEC. Oil prices soared. The abrupt surge triggered a huge transfer of wealth by draining ever-increasing funds away from the industrialized world and poor nations alike to meet the higher energy bills.

Now, the abrupt drop in oil prices may be heralding a different—and at least as dangerous — economic era. "We may be seeing a new chapter where oil prices . . . are getting loose, going up and down like a yo-yo," says Robert Mabro, an energy economist at Oxford University. "Neither world governments nor oil companies are geared for that. We can't tell what the consequences are because we have no experience. We just don't know how to plan for something like this."

Whatever the benefits to energy users, the slide in oil prices already has had some major adverse effects:

—Industrialized countries are easing up on their efforts to seek alternative sources of energy. Conversions to coal are slowing down. Synthetic-fuel projects and nuclear-power plants are being postponed or scratched. Research on new types of energy is being delayed.

—Corporations are draining their oil inventories. The U.S. government has slowed its program of building up a strategic petroleum reserve.

—Because of lower prices, oil revenues are plunging for both OPEC and non-OPEC oil producers. Among U.S. neighbors, Mexico and Venezuela are experiencing severe losses in revenues they can ill afford because of their large populations and internal politics. Elsewhere Egypt, Nigeria and Indonesia are encountering difficult times with the loss of oil revenues placing new strains on social and political cohesion. Development programs are being trimmed, imports cut back. The effect of all that goes out to further depress a slow world economy.

—Industrial decision-making is being paralyzed. Oil companies can no longer forecast demand accurately. Moreover, their earnings are depressed; so they are paying lower taxes to their governments, scratching new projects and letting new oil sources lie untapped. As the effects ripple out, refiners, drillers and pipeline manufacturers are feeling the pinch long before consumers feel the benefits of lower oil prices.

"There is a self-perpetuating element in this crisis as long as producers and consumers don't have a program to handle it," Mr. Levy, the consultant, says.

Auto Makers' Problems

As a striking example of the effects of the current uncertainty, the auto makers are cited by Harold Brown, an economist at the Hudson Institute, a think tank in Croton-on-Hudson, N.Y. "That industry," he says, "has been reported to be spending well over $80 billion in retooling to make smaller, energy-efficient cars. Because it seems possible, if not probable, that oil prices will decline in real terms over the next several years, the public may soon regain much of its former taste for larger, more luxurious cars."

The upshot, Mr. Brown says, could be "a shattering experience" for the weaker auto companies. Moreover, the surviving auto makers could face still another huge switch if oil prices go up again and the public taste changes again. Similar nightmares are rattling other industries around the world as they watch oil prices decline and as they wonder whether a rebound is likely soon. And their executives are hardly reassured when the oil companies themselves readily admit to their own confusion about what may happen next.

Howard C. Kauffmann, president of Exxon Corp., the world's largest oil company, openly concedes that "forecasting oil demand these days can be a bit like solving Rubik's cube—except that there are no pamphlets available to let one peek at the right answer."

More than anyone else, the oil companies are well aware how steadily, almost unremittingly, demand for their crude oil and their refined products is falling. Tor Meloe, the chief economist of Texaco Inc., says non-Communist world demand for oil, which fell a total of 10% in the past two years to about 47 million barrels a day, is plunging again this year.

Recession Noted

"The decline has accelerated with the deepening of the economic recession," he says. "In the last several months, petroleum demand in most industrial countries has been falling at an annual rate of close to 7%." He sees no indication that the bottom will be reached in the next few months. "In fact," he says, "continuing conservation and conversion to alternate fuels will still require production cutbacks from current levels even after recovery from the present recession."

The recession is partly responsible for the current confusion about how much further demand may fall and how long demand may languish at relatively low levels. No one knows how much the drop in demand should be attributed to structural changes in consumption habits—which are relatively permanent—and how much to the recession —which is reversible.

Without this knowledge, oil users are making decisions that may come back to haunt them. They may be depleting oil inventories too far and may be slowing the transition to other forms of energy too much.

"Just wait until June," says Marcus Nadjmi, an oil analyst with American Middle East Research, a New York consulting firm. "Summer demand for gasoline will start, and stockpiling for the winter will begin. Then everyone will discover they bled their inventories too far. There will be a surge in buying, and the rest is old history"—the history of the painful price shocks in 1973-74 and again in 1979. After oil gluts similar to the current one, a sudden rush to buy pushed prices up rapidly; in the latest episode, oil surged from about $12.50 a barrel in January 1979 to as high as $40 a barrel in early 1981.

Divergent Views

Most economists warn that another oil shock of this dimension could push the world economy into a depression. But not all of them are so pessimistic. Some economists contend that energy conservation has progressed too far for history to repeat itself. And they also believe that even though oil prices have slipped, they are still high enough to stimulate further conservation.

Whether viewed as good news or bad, the recent decline in oil prices has been fairly steep. Britain's North Sea oil, for instance, has dropped from $36.25 a barrel last June to $31 currently; in the past month alone, the price slid $3.50 a barrel. Also in the past month, Iran—one of OPEC's price hawks—rolled its official price back $4 a barrel. Mexico and Venezuela went down $2.50 in the past two weeks. Egypt, Norway and several American companies are offering substantial discounts, and so are OPEC countries that are retaining their official prices.

As a result, oil-producing countries' revenues are shrinking. Every dollar discount by Britain takes away the equivalent of $450 million in taxes and royalties. Poorer countries with big populations—such as Mexico, Nigeria, Indonesia, Egypt and Iran—are suffering far more. As they are forced to curtail development plans, social strains are beginning to show.

In Venezuela, for example, opposition parties are blaming the government for allegedly misleading the country and mishandling oil policy.

"All these countries have become accustomed to high levels of spending and development. Putting sudden brakes on that will be very hard, very risky politically," a senior Kuwaiti economist says. "They are putting the blame squarely at Saudi Arabia's feet, and I think they're right. It will get worse if prices really deteriorate. By overproducing so much for so long, our Saudi friends may have released a Frankenstein monster they can no longer control."

Renewable FUELS

Renewable Fuels Association
499 S. Capitol Street, Suite 420
Washington, D.C. 20003
(202) 484-9320

David E. Hallberg
President/Chief Executive Officer

ATTACHMENT E

ALTERNATIVE FUELS IN THE MARKETPLACE: THE REAL COST OF A BARREL OF IMPORTED OIL

With the decontrol of crude oil prices and the Reagan Administration's commitment to reducing federal expenditures, it is fashionable for people to claim that the Nation can solve its energy problems simply by relying on "the laws of supply and demand in the marketplace". While the goal of reducing government involvement wherever possible is worthy of support, it is extremely unrealistic to expect that the timely development of a domestic alternative energy industry will result from reliance on the workings of a non-existent marketplace. This is true due to: (1) the ability of Saudi Arabia and other OPEC members to over-produce at will, thus artifically holding down crude oil prices long enough to make alternative energy investments uneconomic; and (2) the fact that the "market-place" greatly undervalues the true cost of a barrel of imported crude oil to American consumers and taxpayers, thus putting alternatives at a competitive disadvantage.

This second obstacle to alternative energy development should be of great concern, since it is rarely ever taken into consideration by policymakers when developing national energy programs. The fact that the "external costs" of a barrel of imported crude oil -- that is, those costs that are paid by someone other than the producer (oil company) or buyer (motorist) -- are not used in computing the true costs to the Nation obviously means that alternatives to imported oil stand little chance of commercialization if made to compete in a non-existent "marketplace". Recently, in an article by Bernard S. Lee, president of the Institute of Gas Technology, the external costs of a barrel of imported crude oil were computed. The following table shows the true costs of a barrel of foreign oil:

* Benefits from Reduction of Oil Imports by 500,000 Bbls/Day (1980 $/bbl)

	Year 1	Year 3	Longer Term
Direct benefit	$37.00	$38.49	$40.00
External benefits			
Oil price effect	12.41	19.07	12.41
Inflation effect	9.92	23.04	11.90
Employment effect	7.32	22.92	8.78
Security effect	6.71	6.71	6.71
Subtotal	36.36	71.74	39.80
Total benefit	$73.36	$110.23	$79.80

The fact that, in the first year of displacement, each barrel of $37/barrel foreign crude actually costs the U.S. $73.36/barrel is not so surprising when one considers the "externalities" of inflation, unemployment, and national security.

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* "Synthetic Fuels and the Total Cost of Oil Imports", Bernard S. Lee, IGT Gascope, Summer 1980, No. 50

Certainly, the very fact that Americans "export" nearly $10 million each hour to pay for foreign oil means that less funds are available for productive investment in the U.S. The value of the dollar is eroded on international markets, productivity declines, and the price of goods and services increase. This in turn means that jobs are "exported", and unemployment is greatly increased. Finally, if the U.S. were not dependent upon unstable foreign countries for much of its oil, its national security would be strengthened, and costly defense programs like the Rapid Deployment Force ($75 billion over next 8 years) would not be required.

The conclusion is clear. Alternative energy technologies should be made to compete in the "marketplace" with the conventional technologies but on the basis of true costs. When this is done, a great many domestic energy alternatives are competitive right now. However, it is obvious that the federal government must provide incentives to the newly emerging energy alternatives sufficient to enable them to bridge the gap between the "market price" and the "real price" (market price + external costs). In so doing, we will have contributed to our national energy goals, reduced inflation, increased employment, and advanced the national security.

Renewable
FUELS

Renewable Fuels Association
499 S. Capitol Street, Suite 420
Washington, D.C. 20003
(202) 484-9320

David E. Hallberg
President/Chief Executive Officer

ATTACHMENT F

October 6, 1981

Alcohol Fuel Production -- Comparison of Pre 1981 Law with ACRS and Repeal of Energy Investment Tax Credits.

This is in response to Treasury's inquiry concerning the extent to which the alcohol fuels industry would benefit from ACRS and the extent to which such a benefit would offset loss of the energy investment tax credit. For purposes of this comparison, it is assumed that (1) all equipment fall in ADR class 49.5 with an ADR lower limit of 8 years, (2) the property is subject to the half-year convention, (3) a 12% discount rate applies (the same rate as used in estimates under the 1981 Act), and (4) the taxpayer is in the 46% marginal tax bracket.

Based on these assumptions, the value of the depreciation deductions is increased by ACRS from $0.735 per dollar of investment to $0.797. (The present value of the ITC remains the same.) The loss of the energy percentage would be the equivalent of a loss of $0.217 of first year deduction. Consequently, a combination of ACRS plus the repeal of the energy credits would reduce the tax benefits available to most property used in the alcohol fuels industry by $0.155 (deduction equivalent) per $1.00 of investment.

For alcohol fuel equipment, the above comparison is probably overly favorable to ACRS for the following reasons: (1) in the case of new organizations, the "short taxable year" rules of ACRS may result in significant deferral of the depreciation deductions, and (2) many alcohol fuel producers will probably have marginal tax rates of less than 46% making credits relatively more important than deductions.

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Renewable Fuels Association
499 S. Capitol Street, Suite 490
Washington, D.C. 20003
(202) 484-9320

David E. Hallberg
President, Chief Executive Officer

ATTACHMENT G

THURSDAY, FEBRUARY 11, 1982

THE WALL STREET JOURNAL.

Minnesota Gas Drops Alcohol Plant Project, Cites Reagan's Budget

By a WALL STREET JOURNAL Staff Reporter

MINNEAPOLIS—Minnesota Gas Co. said it withdrew from a $85 million project to build an alcohol plant because of Reagan budget proposals to eliminate certain energy tax credits.

The utility was a 75% partner in Minnesota Alcohol Producers, a partnership formed to build the plant, which was to be situated in Mankato, Minn.

Other partners include Johnson Bros. Corp., a Litchfield, Minn., heavy construction and engineering concern, and Renville Agro-Energy Corp., Renville, Minn., an investor group.

A Minnesota Gas spokesman said elimination of federal energy investment tax credits, and of an excise tax exemption for gasohol, would make the proposed alcohol plant economically unfeasible. Construction was to begin this spring, with operation starting in 1984. The plant was to produce 20 million gallons of anhydrous ethyl alcohol annually, to be blended with gasoline for commercial sale.

A Minnesota Gas spokesman said the uncertainty resulting from "on-again, off-again energy policies" makes long-range planning difficult, and makes it impossible to proceed with projects such as the alcohol plant.

Other partners couldn't be reached for comment.

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Renewable Fuels Association
499 S. Capitol Street, Suite 420
Washington, D.C. 20003
(202) 484-9320

David E. Hallberg
President/Chief Executive Officer

ATTACHMENT H

Annual Changes in State Economic Activity and Tax Receipts Resulting from Production and Sale of Output from a 50 Million-Gallon-Per-Year Fuel Ethanol Plant ($ in millions). Prepared for DOE Office of Alcohol Fuels by RPA, Inc.

State	Annualized Increase in State Economic Activity	Net Change in Local and State Receipts	Net Change in Federal Tax Receipts
Alabama	$ 247	$ 3	$ 29
Arizona	268	18	34
Arkansas	257	(31)	31
California	269	(6)	34
Colorado	258	18	32
Connecticut	137	3	7
Delaware	323	26	45
Florida	304	(8)	41
Georgia	247	16	29
Idaho	231	12	26
Illinois	264	16	33
Indiana	266	15	33
Iowa	195	(13)	19
Kansas	236	(2)	27
Kentucky	271	20	34
Louisiana	243	(20)	29
Maine	85	7	(3)
Maryland	316	24	43
Massachusetts	129	10	6
Michigan	269	(7)	34
Minnesota	241	(1)	28
Mississippi	233	17	27
Missouri	286	17	37
Montana	214	(3)	23
Nebraska	192	(8)	18
Nevada	79	7	(4)
New Hampshire	90	5	(2)
New Jersey	375	20	55
New Mexico	242	(13)	28
New York	280	25	36
North Carolina	254	(3)	31
North Dakota	177	4	15
Ohio	310	(1)	42
Oklahoma	258	(16)	32
Oregon	239	14	28
Pennsylvania	247	19	29
Rhode Island	129	9	6
South Carolina	240	(8)	28
South Dakota	182	2	16
Tennessee	255	17	31
Texas	235	13	27
Utah	261	4	32
Vermont	90	7	(2)
Virginia	255	(19)	31
Washington	246	10	29
West Virginia	225	17	25
Wisconsin	247	19	29
Wyoming	249	10	30

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Renewable Fuels Association
499 S. Capitol Street, Suite 420
Washington, D.C. 20003
(202) 484-9320

David E. Hallberg
President, Chief Executive Officer

ATTACHMENT I

ENERGY USERS REPORT

March 4, 1982

Taxation

ENDING FOUR-CENT GASOHOL TAX EXEMPTION WOULD KILL ALCOHOL FUELS, CRS STUDY SAYS

Repealing the four-cent-per-gallon tax exemption for gasohol would destroy the alcohol fuels industry in the U.S., according to a February 26 report by the Library of Congress' Congressional Research Service.

Members of the alcohol fuels industry surveyed for the CRS report said unanimously that without the four-cent tax advantage, "alcohol fuels as an energy alternative would be totally destroyed." Most also agreed that even a serious discussion of repealing the tax advantage would have "strong adverse consequences" for the alcohol fuels industry by discouraging investment in construction of alcohol fuel plants.

The tax exemption for alcohol-gasoline blends, scheduled to run through 1992, the corresponding 40-cent- and 30-cent-per-gallon alcohol fuel credits, and the 10 percent biomass investment tax credit for alcohol fuel production equipment available through 1985 are among the business energy tax incentives President Reagan put on the chopping block in his January 26 State of the Union address.

The proposal to repeal alcohol fuel production incentives faces strong opposition in Congress from Senate Finance Committee Chairman Robert Dole (R-Kan), who said it would be "almost tragically short sighted to cut off incentives to an industry still developing" (EUR, February 4, 1982, p. 119).

Representative Philip R. Sharp (D-Ind), who chairs the House Energy Committee's Fossil and Synthetic Fuels Subcommittee, predicted that Congress would not adopt the Administration's proposal. "If the U.S. wants to play into OPEC's hands," he said, "using stable oil prices to justify killing the alcohol fuels industry is one way to do it."

Industry's Opinions

David Hallberg, president of the Renewable Fuels Association, told CRS the infant alcohol fuels industry cannot cope with Saudi Arabia's manipulation of the market without Government assistance. Repealing the tax break would have a "disastrous" impact on the industry, he said.

Mo Campbell of Mar-Cam Industries, a leading marketer of alcohol fuel, agreed with Hallberg's assessment. "Its real simple: there'd be no industry left" without the tax incentive, he said. He suggested that perhaps the largest alcohol fuel producer, Archer-Daniels-Midland, could remain in business, but the other producers would be out.

Dick Burkett of Archer-Daniels-Midland said that gasohol would have to sell at a price 6 cents to 7 cents higher than premium gasoline without the tax exemption, and in that situation, "it'll probably die." According to the CRS report, Burkett "bitterly attacked what he saw as the Government's practice of promising benefits to industry, then yanking those benefits away after substantial funds had been invested by private firms."

Paul Burke of Texaco, the only major oil company to vigorously promote gasohol and sell the fuel as its own product in its service stations, said removing the exemption would "pull the pins out from the fledgling industry."

All industry spokesmen predicted a disastrous effect if the production incentives are repealed, but some also predicted that the repeal proposal has a slim chance of becoming reality. "We're convinced the proposal's going nowhere," Hallberg told BNA, because "you can't have a stop-start tax policy," and because people still have visions of the gasoline lines and know that things can change very quickly.

Reagan's Rationale

Although alcohol fuel advocates said producers need protection as an "infant industry," the Reagan Administration argued that support for alcohol fuels is unnecessary because the technology for making alcohol from agricultural crops is well known, the report said.

The Administration requested rescission of loan guarantee funds for alcohol fuels production provided by the 1980 Energy Security Act, and Congress agreed to rescind half of the $1.2 billion authorized for the loans. Administration spokesmen used the four-cent tax exemption as a rationale for eliminating the loan guarantee funds. According to the report, Office of Management and Budget Director David Stockman told the congressional Alcohol Fuels Caucus in March 1981 that "We've made no recommendation to change it [the four-cent tax exemption] and I can guarantee we won't."

The Treasury Department's technical explanation of the business energy tax credit repeal proposal said the four-cent-per-gallon tax exemption and corresponding credits of 40 cents per gallon of alcohol (190 proof or more) and 30 cents per gallon of alcohol (150 to 190 proof) produced for alcohol fuel would be repealed for fuels produced or sold after December 31, 1982. A tariff imposed on imported alcohol fuel also would be repealed.

Transition rules to "ease the impact" of the repeal would allow facilities currently producing alcohol fuel to claim the 40-cent and 30-cent credits through 1985, and would phase out the credits by 10 cents per year after that (EUR, February 25, 1982, p 203).

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Renewable FUELS

Renewable Fuels Association
499 S. Capitol Street, Suite 420
Washington, D.C. 20003
(202) 484-9320

David E. Hallberg
President/Chief Executive Officer

ATTACHMENT J

March 10, 1982

Mr. John E. Chapoton, Esq.
Assistant Secretary of the Treasury
for Tax Policy
Room 3120, Main Treasury Building
Washington, D.C. 20220

Dear Mr. Chapoton:

It has come to my attention that of the Office of Tax Analysis (OTA) estimates the combined revenue loss from the excise tax exemptions for gasohol and the alcohol fuel credit will be as follows:

Fiscal year	Millions of dollars
1981	100
1982	140
1983	215
1984	295
1985	370

The estimate for fiscal year 1981 (October 1 1980 through September 30, 1981) requires that 250 million gallons of alcohol be used for fuel. Industry figures, however, indicate that no more than 80 million gallons of ethanol were used for fuel in FY 1981.

(Source: Information Resources Incorporated).

This would indicate a maximum revenue cost to the Treasury of $32 million. This figure does not take into account any positive tax returns to the Treasury through increased sales tax revenues and larger personal income tax revenues.

Current industry projections indicate that the direct revenue cost to the Treasury from the excise tax exemptions for gasohol and the alcohol fuel credit will be as follows:

Fiscal year	Millions of dollars
1982	62.8
1983	93.1
1984	132.0
1985	196.0

(Source: Information Resources Incorporated).

These estimates are based on the following assumptions: (1) continuation of the present tax benefits for alcohol fuels at their present levels, (2) continuation of the tariff on imported alcohol as provided under present law, and (3) oil price increases at approximately the general rate of inflation.

It appears that the estimates made by OTA are based on assumptions that oil prices would increase faster than the general rate of inflation and that the government would institute significant non-tax programs to encourage domestic fuel alcohol production. While these assumptions (and projections based upon them) may well have been reasonable when initially made during the development of the Crude Oil Windfall Profits Tax Act of 1980, the assumptions are no longer appropriate, and the estimates based on them substantially overstate the revenue loss associated with the alcohol fuel credit and excise tax exemption.

I hope this information is of assistance to you in refining your revenue estimates. If I can furnish you with any additional information please contact me.

Sincerely,

David E. Hallberg
David E. Hallberg

DEH:csy

ATTACHMENT K

Renewable
FUELS

Renewable Fuels Association
499 S. Capitol Street, Suite 420
Washington, D.C. 20003
(202) 484-9320

David E. Hallberg
President/Chief Executive Officer

REAGAN ADMINISTRATION STATEMENTS ON ALCOHOL FUELS TAX INCENTIVES

"I favor the widespread use of gasohol. Already being sold at more than 800 service stations in the U.S., it is on the verge of making a significant contribution to our gasoline supplies. And since the ethyl alcohol used to produce gasohol can be distilled from grain crops grown in the U.S., its use reduces our need to import foreign oil.

At present, gasohol is exempt from the 4¢ per gallon federal gasoline tax. I would maintain this exemption..."

—Candidate Ronald Reagan - January 31, 1980

* * * * * * * * * * * * * * * * * *

Congressman Cooper Evans: "...can you really give us assurance that 4 cents on the gasoline tax, investment credits, and [the alcohol fuel tax incentives] program are going to stay in place?"

OMB Director David Stockman: "Well, from my point of view, yes ... we have made no recommendations or changes and I can guarantee you that we wouldn't in the future. Insofar as the investment tax credit ... including alcohol production equipment, we have no intention of making recommendations or changes there."

—David Stockman's Address before the Congressional Alcohol Fuels Caucus - March 16, 1981

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"The Administration will support continuation of tax incentives for alcohol fuels..."

—page 4-3 of the White House release of the Program for Economic Recovery - February 18, 1981

STATEMENT OF RICHARD L. HANNEMAN, DIRECTOR OF GOVERNMENT AND PUBLIC AFFAIRS, NATIONAL SOLID WASTES MANAGEMENT ASSOCIATION, WASHINGTON, D.C.

Senator **Packwood**. Mr. Hanneman, why don't you go ahead and then we will have some questions.

Mr. **Hanneman**. Thank you, Mr. Chairman. I appreciate the opportunity to be here with you. And I appreciate your leadership and Mr. Matsunaga's role and leadership in support of the energy tax credit.

I think perhaps we should have been invited to appear before you on Wednesday because many of the issues in regard to resource recovery, energy from waste facilities, were discussed at that point. And at that point in the discussions of IDB availability for these projects, the National League of Cities and U.S. Conference of Mayors urged specifically that IDB's be retained and their availability assured for energy from waste projects. And we certainly agree with that.

Our association, the National Solid Wastes Management Association, represents about 2,000 private companies that collect, process, and dispose of solid wastes and hazardous wastes. And, specifically, we own, build, and operate resource recovery facilities. These facilities are those which receive wastes from a conventional garbage truck, and extract the materials, and combust the remainder for its energy value. The remainder is about 30 percent that can't be burned and that goes into a landfill.

There are projects in both Portland and Honolulu. The Portland project, just for example, will receive 1,700 tons of refuse a day and cost $141 million. These projects range anywhere from a modest size of $60 million up to a quarter of a billion dollars. And their project financing is dependent entirely on the availability of IDB's. We strongly urge that the administration's efforts to restrict these in a way which would make them unavailable to us be opposed.

We also think that the depreciation schedule which was enacted last year doesn't do us, as an industry, a great deal of good. We would be happy to go back to the way the law was before 1981, if that was the committee's desire. Because the advantages of last year's law are certainly not as great as the possibility on the other side of losing IDB's, or being forced to go to a straight line, 12-year writeoff.

We, as an association, have taken the position that tax incentives for waste to energy are a very good way to proceed to provide the difference between what the market would normally bring on line and the communities' desires to bring these on line faster. Without a little subsidy, the communities will still eventually get to this because they are losing their available land disposal facilities. But this timeframe will be stretched out. With tax-exempt financing, we think we are able to move up that timetable and stop wastes going into open dumps that much sooner. Communities will be able to pass along all the savings that this stimulus gives to the consumer in lower tipping fees. Without this as well, project financings will not be occurring.

And to respond to Mr. Matsunaga's question of an earlier witness, there have been no project financings now, in the last 9 months or so, when we have 12 projects which are awaiting financing right now. And we would like to see this resolved very quickly so that they can see what the cost is going to be.

These projects will be built sooner or later. They will be built by the municipality if we don't build them. But if we build them, they can be done cheaper, and the cost to consumers—who are each of us—will be that much less.

The IDB's for resource recovery serve an essential public purpose, in fact, a municipal function. If we don't do it, in fact, the municipality must provide it because it is a public health function to provide disposal. And so, in any test of trying to define whether or not an IDB is being misused, we think that you will certainly agree that an energy from wastes facility will qualify.

Turning to the energy tax credit, that has been mostly useful to people who are engaged in materials recovery. That is, extraction of the paper, metals, glass from the waste stream, and its sale as a material. This has obvious energy conservation benefits. We certainly encourage its continuance and appreciate the support of the committee for that.

I would be pleased to respond to any questions which you might have.

[The prepared statement follows:]

PREPARED STATEMENT BY RICHARD L. HANNEMAN, DIRECTOR, GOVERNMENT AND PUBLIC AFFAIRS, NATIONAL SOLID WASTES MANAGEMENT ASSOCIATION

I AM RICHARD L. HANNEMAN, DIRECTOR OF GOVERNMENT AND PUBLIC AFFAIRS FOR THE NATIONAL SOLID WASTES MANAGEMENT ASSOCIATION (NSWMA), THE NATIONAL ORGANIZATION REPRESENTING THE PRIVATE SECTOR OF THE WASTE SERVICE INDUSTRY. MEMBERS OF OUR INDUSTRY BUILD AND OPERATE SOLID WASTE DISPOSAL AND ENERGY RECOVERY FACILITIES INCLUDING LANDFILL GAS RECOVERY SYSTEMS. THESE FACILITIES RECEIVE SOLID WASTE FROM HUNDREDS OF PRIVATE REFUSE COLLECTORS, BUSINESSMEN WHO MAKE UP THE VAST MAJORITY OF MEMBERS OF NSWMA. OUR MEMBER COMPANIES ALSO INCINERATE, TREAT AND DISPOSE OF HAZARDOUS INDUSTRIAL CHEMICAL WASTES.

I AM HERE TODAY TO TELL YOU THAT THE ADMINISTRATION'S RECOMMENDATIONS TO RESTRICT INDUSTRIAL DEVELOPMENT BOND FINANCING AND ELIMINATE ENERGY TAX CREDITS FOR SOLID WASTE DISPOSAL FACILITIES ARE ILL CONCEIVED. THEIR ADOPTION WOULD HAMSTRING THE TIMELY DEVELOPMENT OF WASTE-TO-ENERGY PLANTS JUST AS THAT PROCESS IS FINALLY GAINING MOMENTUM.

OUR INDUSTRY IS BEING REGULATED STRINGENTLY AND APPROPRIATELY BY THE FEDERAL AND STATE GOVERNMENTS TO ENSURE THAT DISPOSAL OF SOLID AND HAZARDOUS WASTES ARE ACCOMPLISHED IN AN ENVIRONMENTALLY SAFE MANNER. OWING LARGELY TO THE REGULATIONS, OUR INDUSTRY IS MOVING TOWARD ENERGY RECOVERY WASTE DISPOSAL PLANTS IN KEEPING WITH THE CONGRESSIONAL MANDATE TO INCREASE ENERGY INDEPENDENCE.

TO ENCOURAGE US TO MEET THESE TWO GOALS, EXISTING TAX LAW ENCOURAGES PRIVATE SECTOR INVESTORS TO SUPPORT ENERGY-PRODUCING GARBAGE DISPOSAL FACILITIES. THE LOCAL COMMUNITIES WHICH THESE FACILITIES SERVE WILL BENEFIT THROUGH REDUCED COSTS TO DISPOSE OF THEIR WASTES IN THE LONG RUN. THE ADMINISTRATION'S PROPOSALS WILL INCREASE DISPOSAL FEES AND WILL DELAY PROCUREMENT OF WASTE-TO-ENERGY FACILITIES BY REDUCING FINANCING

ALTERNATIVES AVAILABLE TO COMMUNITIES. EVENTUALLY, THE COMMUNITY WILL PROBABLY PURCHASE THESE FACILITIES, BUT THE DELAY WILL BE COSTLY.

SOLID WASTE DISPOSAL FACILITIES TODAY REPRESENT A UNIQUE PARTNERSHIP BETWEEN THE PRIVATE SECTOR AND THE PUBLIC SECTOR AT THE LOCAL, STATE AND FEDERAL LEVELS. LET ME EXPLAIN THIS RELATIONSHIP BECAUSE IT IS KEY TO WHY I AM HERE TODAY.

THE LOCAL COMMUNITY HAS A RESPONSIBILITY TO ENSURE THAT SOLID WASTE DISPOSAL OCCURS IN AN ENVIRONMENTALLY SAFE AND COST-EFFECTIVE MANNER. THE ENVIRONMENTAL STANDARDS ARE ESTABLISHED BY STATE AND FEDERAL REGULATORY AGENCIES. HOWEVER, ABOUT THREE-FOURTHS OF ALL REFUSE COLLECTION IS PERFORMED BY THE PRIVATE SECTOR. BOTH COLLECTION AND DISPOSAL COSTS ARE INCREASING DUE TO RISING ENERGY PRICES FOR TRANSPORTATION AND RISING CONSTRUCTION COSTS TO MAKE LANDFILLS ENVIRONMENTALLY SAFE. TODAY, PRIVATE COMPANIES ARE USUALLY ABLE TO FINANCE LANDFILL SITE ACQUISITION AND CONSTRUCTION COSTS. THIS IS NOT TRUE FOR MAJOR RESOURCE RECOVERY FACILITIES WHOSE COSTS CAN APPROACH $250 MILLION.

RISING COSTS HAVE MOVED MANY COMMUNITIES TO EXAMINE DISPOSAL ALTERNATIVES TO LANDFILLS WHICH MAY BE ECONOMICAL IN THE LONG RUN. SOME COMMUNITIES SIMPLY DO NOT HAVE ANY REMAINING ENVIRONMENTALLY SAFE AREAS FOR NEW MAJOR LANDFILLS WITHIN THEIR BOUNDARIES. THUS, MOST ALTERNATIVES BEING EXAMINED TODAY CENTER AROUND A WASTE-TO-ENERGY FACILITY OF SOME TYPE WHICH IS ABLE TO TAKE ADVANTAGE OF RISING ENERGY COSTS OVER THE LONG TERM. WASTE-TO-ENERGY FACILITIES CAN TECHNICALLY AND ECONOMICALLY PROVIDE A SOLID WASTE DISPOSAL OPTION OVER A LONG PERIOD WHICH I VIEW AS AT LEAST 20 YEARS.

IN THE 1970s, MANY RESOURCE RECOVERY PROJECTS WERE BUILT USING A VARIETY OF TECHNOLOGIES. THOSE BUILT WITH THE OBJECTIVE OF RELIABLE DAY-IN DAY-OUT DISPOSAL OF SOLID WASTE HAVE BEEN SUCCESSFUL. BY CONTRAST, THOSE

FACILITIES WHOSE OBJECTIVE WAS TO RECOVER AND RECYCLE MATERIALS OR PRODUCE HOMOGENEOUS FUELS FROM THE WASTE STREAM HAVE, FOR THE MOST PART, MET WITH TECHNICAL DIFFICULTIES AND ARE OPERATING AT SIGNIFICANTLY REDUCED CAPACITY OR STAND IDLE. THEIR PROPONENTS OVERLOOKED THE PROBLEM THAT GARBAGE IS NOT SOMETHING THAT CAN BE HELD IN INVENTORY UNTIL THE TECHNICAL PROBLEMS ARE SOLVED.

DURING THE 1970s, THE FEDERAL GOVERNMENT AND THE CONGRESS RECOGNIZED THE NATIONAL SCOPE OF SOLID WASTE DISPOSAL PROBLEMS, AND ADDITIONALLY RECOGNIZED THE CONTRIBUTION THAT BURNING SOLID WASTES COULD MAKE IN OFFSETTING FOSSIL FUEL USAGE. THE RESOURCE CONSERVATION AND RECOVERY ACT OF 1976 (RCRA) LISTED SPECIFIC GOALS FOR SOLID WASTE DISPOSAL AND RECOVERY OF USABLE ENERGY AND MATERIALS. THE ENERGY SECURITY ACT OF 1978 FURTHER RECOGNIZED THE ENERGY CONTRIBUTION OF THIS INDUSTRY. THESE TWO ACTS REPRESENT A MANDATE BY CONGRESS TO DISPOSE OF SOLID WASTE IN AN ENVIRONMENTALLY SOUND MANNER AND TO ENCOURAGE THE DEVELOPMENT OF ENERGY RECOVERY FROM SOLID WASTE.

THESE FEDERAL INITIATIVES, FOLLOWED IN MANY INSTANCES BY PARALLEL STATE INITIATIVES, TOOK TWO FORMS WITH RESPECT TO FINANCING PROJECTS. ONE FORM WAS PROJECT-SPECIFIC ASSISTANCE SUCH AS STUDY GRANTS, CONSTRUCTION GRANTS AND LOANS FOR UNIQUE PROCESSES, R&D LOANS, LOAN GUARANTEES, PRICE SUPPORT LOANS AND ENTITLEMENTS. NSWMA OPPOSED THESE FINANCING PROGRAMS VIGOROUSLY BECAUSE THEY TENDED TO PIT "GRANTSMEN" AGAINST LEGITIMATE PRIVATE-SECTOR CORPORATIONS WHO HAVE THE TECHNICAL AND FINANCIAL BASIS TO COMPLETE A PROJECT AND MAKE IT WORK. FURTHER, COMMUNITIES TENDED TO LINE UP HOPING FOR FEDERAL FUNDS. THEY DELAYED SOLVING THEIR SOLID WASTE PROBLEMS. I AM GLAD TO SEE THAT NONE OF THESE PROGRAMS ARE CURRENTLY BEING FUNDED BY THE ADMINISTRATION OR CONGRESS.

THE SECOND FISCAL INITIATIVE SPONSORED BY THE FEDERAL GOVERNMENT WAS IN THE FORM OF TAX INCENTIVES TO ENCOURAGE PRIVATE SECTOR PARTICIPATION IN RESOURCE RECOVERY PROJECTS. WE SUPPORTED THIS TYPE OF RELATIVELY NEUTRAL STIMULUS BY THE FEDERAL GOVERNMENT BECAUSE IT PLACES ALL VENDORS ON THE SAME FOOTING WHEN COMPETING FOR A PROJECT AND AT THE SAME TIME ALLOWS CERTAIN TAX BENEFITS TO BE PASSED ON TO INVESTORS WHO PROVIDE THE FUNDS. LOCAL COMMUNITIES ARE THEN ABLE TO BENEFIT THROUGH LOWERED DISPOSAL COSTS. EQUALLY IMPORTANT, BECAUSE TAX PROGRAMS HAVE BEEN RELATIVELY SLOW TO CHANGE, WHEN COMPARED TO GRANT AND LOAN GUARANTEE PROGRAMS, PRIVATE COMPANIES AND COMMUNITIES WERE ABLE TO MAKE LONG-RANGE PLANS FOR PROJECT FINANCING. TODAY, HOWEVER, TAX INCENTIVE PROGRAMS ARE BEING QUESTIONED, INTRODUCING UNCERTAINTY WITH RESPECT TO FINANCING ALTERNATIVES. THE IDB PROPOSALS BY THE ADMINISTRATION ARE CAUSING UNCERTAINTY AMONG INVESTORS AND ARE DISRUPTING PLANS THAT HAVE BEEN WORKED OUT OVER THE PAST 12-24 MONTHS WITH SPECIFIC COMMUNITIES. THIS DISRUPTION WILL CAUSE DELAYS IN PROJECT IMPLEMENTATION WHICH CAN BE TRANSLATED INTO GREATER COST TO THE CITIZENS AND DELAY IN IMPLEMENTING ENVIRONMENTAL STANDARDS.

WE ARE AWARE OF OVER 100 COMMUNITIES PLANNING SOLID WASTE DISPOSAL FACILITIES TODAY IN THE U.S. AND PROJECT THAT ONE-THIRD MAY BE BUILT IN THE NEXT 10 YEARS IF FINANCING IS AVAILABLE. THIRTY TO FORTY OF THESE PROJECTS WILL COST IN EXCESS OF $60 MILLION FOR THE CAPITAL OUTLAY ALONE. MOST OF THE FACILITIES WILL INCLUDE AN ENERGY RECOVERY OPTION IN THE FORM OF ELECTRICITY, STEAM OR BOTH. SEVERAL COMMUNITIES ARE CONSIDERING REPLACING FOSSIL-FUEL DISTRICT HEATING PLANTS WITH A SOLID WASTE-TO-ENERGY SYSTEM AS THE HEAT SOURCE. IN THE PAST YEAR, 12 LOCAL AUTHORITIES HAVE SELECTED A VENDOR TO CONSTRUCT AND OPERATE A MAJOR WASTE-TO-ENERGY PLANT. THESE 12 PLANTS COULD BE OPERATIONAL WITHIN THE NEXT 3-4 YEARS. ALL OF THESE

COMMUNITIES ARE ATTEMPTING TO OBTAIN FINANCING; HOWEVER, NONE HAVE TO [illegible]E. THE ADMINISTRATION'S PROPOSAL IS EXACERBATING THIS SITUATION.

AS THE SITUATION NOW STANDS, COMMUNITIES ACTING UNDER THE FEDERAL AND STATE MANDATE TO GIVE UP OUTMODED AND ENVIRONMENTALLY UNSOUND OPEN DUMPS AND INCINERATORS ARE STUDYING TECHNOLOGY-BASED WASTE VOLUME REDUCTION FACILITIES AND, WHERE ECONOMICAL IN THE LONG TERM, WILL PROBABLY PROCURE ONE. THEY ARE, FOR THE MOST PART, LOOKING TO THE PRIVATE SECTOR TO BUILD AND OPERATE THE FACILITY AND TO OWN THE FACILITY IF POSSIBLE. WE BELIEVE, HOWEVER, THAT MOST FACILITIES WILL BE AT LEAST IN PART PUBLICLY OWNED.

FINANCING WASTE-TO-ENERGY FACILITIES IS PROVING TO BE DIFFICULT. PRIVATE COMPANIES ARE NOT GOING TO PERMIT SUCH A LARGE DEBT TO APPEAR ON THEIR BOOKS. MANY COMMUNITIES DO NOT HAVE AVAILABLE AUTHORITY TO FUND A PROJECT THROUGH GENERAL OBLIGATION BONDS. THUS, THE PRINCIPAL FINANCING INSTRUMENT AVAILABLE IS TAX-EXEMPT INDUSTRIAL DEVELOPMENT BONDS. WHEN CERTAIN OTHER TAX INCENTIVES ARE INCLUDED, A FINANCING PACKAGE MAY BE DEVELOPED WHICH WILL INCLUDE PARTICIPATION BY ALL CONCERNED PARTIES.

THE POINT OF MY PRESENTATION IS THAT THE ADMINISTRATION PROPOSES TO REDUCE OR ELIMINATE MANY OF THE TAX BENEFITS THAT SERVE TO ATTRACT INVESTORS TO WASTE-TO-ENERGY PROJECTS. ELIMINATION OF THESE INCENTIVES WILL RESULT IN PROJECT DELAYS AT A MINIMUM. THE FLEXIBILITY AVAILABLE TO COMMUNITIES TO IDENTIFY AND OBTAIN FINANCING BECOMES MORE LIMITED AND MORE EXPENSIVE.

A MUNICIPALITY AND PRIVATE SECTOR INVESTORS CONCERNED MAY WISH TO CONSIDER FINANCING ALTERNATIVES WHICH INCLUDE THE USE OF TAX-EXEMPT IDBs (WORTH 250 BASIS POINTS IN INTEREST RATES), ENERGY AND INVESTMENT TAX CREDITS (250 BASIS POINT EACH), AND ACCELERATED DEPRECIATION (250 BASIS POINT). THE ADMINISTRATION HAS PROPOSED ELIMINATION OF THE ENERGY TAX

CREDIT DENYING USE OF ACCELERATED DEPRECIATION WITH TAX-EXEMPT FINANCING AND RESTRICTING THE USE OF ARBITRAGE. WITH FINANCING OPTIONS REDUCED, A MUNICIPALITY WILL EXPERIENCE AN INCREASE IN INTEREST UP TO FIVE PERCENT. THE COST WOULD BE TRANSLATED INTO AN INCREASED FEE OF FROM $6 TO $8 PER TON. THE EFFECTS OF RESTRICTING ARBITRAGE AND THE ELIMINATION OF CERTAIN SOLID WASTE DISPOSAL STEAM-GENERATING FACILITIES [IRS CODE 103(c)] HAVE NOT BEEN ASSURED TO DATE.

THESE INCENTIVES SHOULD NOT BE ELIMINATED. SUCH A PROPOSAL OVERLOOKS THE FACT THAT PROVIDING WASTE DISPOSAL SERVICES IS A GOVERNMENTAL RESPONSIBILITY WHICH HAS BEEN ENCOURAGED TO DEVELOP INTO A PUBLIC-PRIVATE PARTNERSHIP. AS MENTIONED EARLIER, MANY COMMUNITIES CHOOSE TO OWN THE FACILITIES AND ACCEPT THE ULTIMATE FINANCIAL RISK. IF THE FACILITY GENERATES AND SELLS ENERGY AND THE REVENUES DERIVED ARE USED TO LOWER THE DISPOSAL FEE SO IT CAN COMPETE IN THE WASTE MARKETPLACE, THEN LOGICALLY THE FINANCIAL INSTRUMENTS ISSUED TO PAY FOR ALL COMPONENTS OF THE FACILITY INCLUDING POLLUTION CONTROLS SHOULD ALSO BE TAX EXEMPT. FURTHER, IF THE COMMUNITY CAN OBTAIN INVESTORS THROUGH USE OF TAX INCENTIVES SUCH AS TAX-EXEMPT BONDS AND ACCELERATED DEPRECIATION, INCENTIVES WHICH SERVE TO ADDITIONALLY LOWER THE DISPOSAL FEE, THEN THESE SHOULD ALSO BE PERMITTED. WE SUBMIT THAT THE COMBINATION OF THESE INCENTIVES REPRESENTS THE FEDERAL GOVERNMENT'S PARTICIPATION IN MANDATING THE POLICIES OF SAFE SOLID WASTE DISPOSAL AND ENERGY SECURITY. THEY ARE THE SOLE REMAINS OF A FEDERAL COMMITMENT TO REPLACE ENVIRONMENTALLY-THREATENING "OPEN DUMPS" WITH MODERN WASTE DISPOSAL FACILITIES LIKE RESOURCE RECOVERY PLANTS.

I WOULD LIKE TO POINT OUT THAT TYPICALLY, IT WILL TAKE 3-4 YEARS TO BUILD AND PLACE INTO OPERATION A WASTE-TO-ENERGY FACILITY. THE CONSTRUCTION CONTRACTOR WILL EMPLOY UP TO 200 WORKERS DURING THIS PERIOD.

WHEN COMPLETED, THE FACILITY WILL EMPLOY 60-75 FULL-TIME STAFF. FURTHER, THE FACILITY WILL STILL REQUIRE A LANDFILL FOR THE PROPER DISPOSAL OF INCINERATOR ASH, DEMOLITION WASTE AND OTHER REJECTS. IT WILL, HOWEVER, COMMENCE RETURNING TAXES TO THE TREASURY AS SOON AS CONSTRUCTION BEGINS.

CONCERNING THE ENERGY TAX CREDIT, WHICH THE ADMINISTRATION PROPOSES TO ELIMINATE, ESTIMATES BY EPA AND RECYCLING GROUPS INDICATE THAT UP TO 20% OF THE WASTE STREAM HAS THE POTENTIAL FOR RECYCLING PRIOR TO ARRIVING AT A WASTE-TO-ENERGY FACILITY. THE ABSENCE OF THIS WASTE RESULTS IN LESS COST TO THE COMMUNITY BECAUSE IT ELIMINATES THE DISPOSAL COSTS. RECYCLING ALSO RESULTS IN THE CREATION OF JOBS TO RECYCLE THE PRODUCT. MOST RECYCLERS ARE SMALL BUSINESSMEN WHO ARE ENCOURAGED TO ENTER THE RECYCLING MARKET THROUGH ENERGY TAX CREDITS WHICH THEY RECEIVE ON THE EQUIPMENT THEY USE. THE ENERGY TAX CREDIT SHOULD REMAIN IN PLACE AND BE EXTENDED FOR THE NEXT SEVERAL YEARS FOR EQUIPMENT USED FOR LEGITIMATE RECYCLING OPERATIONS.

FINALLY, HAZARDOUS WASTE FACILITIES ARE NOT CONSIDERED ELIGIBLE FOR IDB FINANCING BY THE IRS, NOTWITHSTANDING THE FACT THAT CONGRESS DEFINED SOLID WASTE TO INCLUDE HAZARDOUS WASTE IN RCRA. WE ENCOURAGE THAT THE DEPARTMENT OF THE TREASURY BE ADVISED OF THE PROVISIONS OF RCRA ENACTMENT IN 1976. THIS CHANGE WOULD BENEFIT PERHAPS 10-20 FACILITIES OVER THE NEXT 10 YEARS.

IN SUMMARY, WE BELIEVE THAT THE ADMINISTRATION'S PROPOSALS WITH RESPECT TO TAX INCENTIVES FOR SOLID WASTE AND POLLUTION CONTROL FACILITIES SHOULD BE REJECTED. RETENTION OF THESE TAX INCENTIVES REPRESENTS AN APPROPRIATE LEVEL OF PARTICIPATION BY THE FEDERAL GOVERNMENT IN PROMOTING ENVIRONMENTALLY SAFE SOLID WASTE DISPOSAL METHODS AS REQUIRED BY RCRA. THEY CONTRIBUTE TO CONSERVING ENERGY AS MANDATED BY THE ENERGY SECURITY ACT OF 1978. THESE INCENTIVES ARE REQUIRED TO ATTRACT INVESTORS TO THESE PROJECTS WHICH IN TURN LOWER THE FEES CHARGED TO THE COMMUNITY. WE BELIEVE THEY SERVE A VALID PUBLIC PURPOSE AND ARE NEEDED TO ENCOURAGE THIS UNIQUE PUBLIC-PRIVATE SECTOR COOPERATION AND PARTNERSHIP NEEDED TO MOVE THE SOLID WASTE INDUSTRY FORWARD.

THANK YOU.

Senator **Packwood**. Excuse me, I was asking Senator Dole a question. I apologize.

I want to ask Mr. Direnfeld a question. Would you fill me in a little bit more about your business? What your background was? What grant you have got? What kind of a contract you have and whatnot?

Mr. **Direnfeld**. My background is an attorney. The creation of the project was in response to the congressional alcohol fuel program. Our intent was to compete for the grants, to compete for loan guarantees, and to try and be the first project to proceed under the program. Of the 743 applicants that originally applied under the program, our company by virtue of the type of engineering and the amount of private resources that were committed, received a commitment from the Department of Energy to guarantee a loan.

Senator **Packwood**. Now, specifically, what is your company going to do? You are converting something to alcohol?

Mr. **Direnfeld**. It is going to be taking 20 million bushels of corn and converting it into 50 million gallons of alcohol. We are going to build the plant in South Bend, Ind., an area that has got over 15 percent unemployment today. The South Bend area has adequate corn supplies. It has a good industrial base and it is an area that suffered very severe dislocations of jobs. We have worked very closely with the local administration. They have assigned numerous people to the project and have involved local citizens. We have received all of our EPA permits. We are going to use coal as a primary source. We have a fixed price contract to build the plant with the Davey McGee Corp. We have bid every item. We have done all this in reliance upon the programs that you, the Congress, have created. Our investment which is in excess of $3½ million, will be worth nothing if the tax credits are eliminated.

We certainly want to take the market risk. And we are willing to accept the fact that as entrepreneurs we should take that risk. But to change course after undertaking a long-term project, and responding to what we perceive to be a very strong national need, is very difficult. I hope that this brief microcase study is useful to your consideration of this issue.

Senator **Packwood**. When would you break ground assuming no change is made in the credits?

Mr. **Direnfeld**. We would anticipate breaking ground in June.

Senator **Packwood**. Senator Matsunaga.

Senator **Matsunaga**. When you use corn to produce gasohol, what effect, if any, would that have on the agricultural price support program?

Mr. **Direnfeld**. While I don't know the full national impact it seems that the farmers in the Indiana area are having the same problems that the farmers are having everywhere. And that is to securing markets for their crops and profitable prices. This explains why agricultural prices have sagged through probably the lowest parity ratio since 1933. And to that extent that we, as alcohol producers, can use domestic corn to provide another market, while at the same time recapturing the protein for animal feed, I think it would have a very salutary effect both on the need to reduce costs for crop support programs as well as enhancing the national balance of payments.

Senator MATSUNAGA. I think this is an aspect of the energy program which has been very much overlooked.

Senator PACKWOOD. Senator Dole.

The CHAIRMAN. I want to thank Senator Packwood for chairing these hearings. He has a particular interest in most of these areas. I have an interest in many of them. I will read the testimony. Mr. Direnfeld, I believe you are substituting, right?

Mr. DIRENFELD. I am pinch-hitting for Dave Hallberg.

The CHAIRMAN. Right. As I understand it, Mr. Hanneman, your testimony raises the same question that someone with Wheelabrator-Frye raised with me recently?

Mr. HANNEMAN. Very much. In fact, we discussed that. They are members of our association.

The CHAIRMAN. Right. The IDB's are used for a public purpose, as I understand it. It's not a private purpose.

Mr. HANNEMAN. No question.

The CHAIRMAN. I don't have any questions. I will be eager to read the testimony.

Senator PACKWOOD. Gentlemen, thank you.

Mr. Direnfeld, thank you for substituting for Mr. Hallberg today. We appreciate it.

Mr. DIRENFELD. Thank you.

Mr. HANNEMAN. Thank you.

Senator PACKWOOD. We will conclude with Mr. Nicholas Loope, Mr. Michael Koleda, and Ms. Suzette Tapper.

STATEMENT OF R. NICHOLAS LOOPE, PRESIDENT, SOLAR ENERGY INDUSTRIES ASSOCIATION, WASHINGTON, D.C.

Senator PACKWOOD. We will begin with Mr. Loope. Why don't you go right ahead, Mr. Loope.

Mr. LOOPE. I am pleased to appear before the committee today to present testimony on behalf of the Solar Energy Industries Association. I want to thank this committee for allowing us to present our views today. And thank you for the support that you have shown the solar energy industry through your support of the tax credits in the past.

In one word, the issue that our industries association is interested in pursuing is that of parity.

Senator PACKWOOD. What?

Mr. LOOPE. Parity. Parity in price, parity in Government support, and parity in Government regulations. For there to be true competition in the free marketplace, there must be parity with respect to the Government's involvement in these areas. Presently, there seems to be a myopic optimism on the part of OMB and Treasury that if the tax credits—in specific, the business energy tax credits for solar—are rendered, that this will increase the revenue flow to the Treasury. Unfortunately, there are not hard numbers available from Treasury to identify the impact of the business tax credits on that cash flow to date. However, there are numbers for the residential energy (solar) tax credit, which is a larger tax credit, as you know, of 40 percent.

In 1980, Treasury identified approximately $1.17 billion of expenditures at the retail level that was eligible for the 40 percent renewable energy tax credit especially solar, purchases. Of that, $151 million was actually realized in tax credits, which is only 12 percent of the expenditure level. The rest was primarily made up in the various State tax credits that exist throughout the United States.

Treasury also estimates that about 22 cents out of every retail dollar finds its way back to the Federal Treasury in terms of personal income tax, corporate income tax and various other related revenue flows, like FICA and licenses. If that is true, that $1.7 billion generated approximately $270 million back into the Federal coffers subtract the $157 million allocated in the form of the tax credit as approximately $70 million to the good. More importantly, the 20 million square feet of solar collectors that were built and installed in that tax year of 1980 offset about $32 million in purchases of oil, which goes directly to improve the balance-of-trade deficit. So in reality, this tax credit of 40 percent was able to contribute about $100 million through use and purchase at the retail level.

We believe the same is true at the commercial and business tax level. Quite frankly, if we take a look at the level of business tax credit that is available today, it does not really allow many businesses to exercise the option of energy conservation or energy generation equipment purchases. It simply is not a good business decision at its present level. We are out of sync with parity in terms of the way fossil fuel use is treated.

If a corporate operating officer makes a proposal to his board to invest several hundred thousand dollars into energy conservation and generation equipment, he is able to show the amount of money that is going to be saved over a period of years. Most capital investment programs are 3, 5, 7, and 10 years in length. He's able to show a return on investment that is greater than the hurdle rate for the corporation. The corporation is generally willing to go ahead with that investment.

However, when the corporation takes a look at that on the cash flow basis in the first year, it is generally very hard to justify these investments. Why? Because there is the ability to expense fossil fuel at the tax base level of that corporation, which is generally 46 percent. Thus, in the first year cash flow situation, which in today's economy is very important for all corporate capital investment decisions, we are out of sync. We have to continue business in, as is today, an inefficient energy consumption manner because we are able to expense fossil fuels.

As a result, the Solar Energy Industries Association is more supportive of enhancing and expanding the present business energy tax credit to a level that would be allowed when coupled with the ITC to, on a first year cash flow basis, be in parity with the expensing of fossil fuel positions.

In effect, this would be a break-even position for the Treasury. In reality, would produce more revenues each year thereafter because when every dollar of energy that would normally be expensed is deferred, this is a savings in cost of goods. Cost of goods drop directly to the net operating profit line, which then becomes taxable. As a result, every year thereafter that energy generating equipment such as solar devices would be deferring the use of fossil fuels, there would be income generated for the Federal coffers.

Gentlemen, we want to thank you again on behalf of the Solar Energy Industries Association for allowing us to express our views toward expansion and enhancement of the business energy tax credits.

Senator PACKWOOD. Mr. Loope, thank you.

[The prepared statement follows:]

TESTIMONY OF THE SOLAR ENERGY INDUSTRIES ASSOCIATION
PRESENTED BY R. NICHOLAS LOOPE, PRESIDENT
BEFORE THE SENATE FINANCE COMMITTEE

I am pleased to appear before the Committee today to present the testimony of the Solar Energy Industries Association (SEIA), of which I have the pleasure to be the current national President. My name is R. Nicholas Loope and I am an executive officer of Sunworks, Inc., a subsidiary of American Smelting and Refining Co. Many of the Fortune 500 companies are involved in solar energy because they see the future of energy production from this source.

SEIA is a membership trade association representing the interests of the solar businesses of our nation. We include among our membership producers of solar equipment, research and development interests, marketing interests, and those involved with the installation of solar equipment. We represent companies which produce between 80 to 90% of all the solar equipment manufactured in the United States. SEIA has in its membership both large, medium and small companies, with about 85% of our members being properly classified as small businesses.

SEIA is in its eighth year of operation and provides many membership services to the 800 members, most of which are company members. The association is divided into various division units representing the different solar technologies.

INDUSTRY PHILOSOPHY ON GOVERNMENT PROGRAMS AND TAX POLICY

Before I comment directly upon the tax issues which are before the committee for determination regarding solar energy, let me make a brief statement regarding the general philosophy of the solar industry toward government programs and tax policies for solar energy.

While there were a few scattered solar companies in the United States before the oil crisis of 1973-74, it was not until that time that American business became serious about building a solar industry. From that point on the federal government was supportive of developing the technology for renewable energy resources and helping to encourage the establishment of a privately-financed industry. In the ensuing years, a build-up in support for solar energy research, development and demonstration was seen. The private sector responded by pouring money into the manufacture of solar equipment and marketing systems for the same. As a result, the flat plate collector, photovoltaic, solar thermal electric and wind technologies started to develop a small industry base. Other technologies were still being developed for commercialization, as well. And the federal government's role in the beginning of all of this was, necessarily, substantial and justified.

Now, some technologies have been well developed and are being commercialized or marketed by the private sector, without great need for the commitment of large federal government budgets for research and development. However, other technologies are still in the research and development stages and have a continued need for federal government involvement.

SEIA supports a solar budget level of $276.19 for FY 1983, almost the identical level of $275.0 provided for FY 1982.

HISTORY OF SOLAR TAX CREDITS

While the monies authorized and appropriated by the Congress for solar research, development and demonstration programs through the Energy Research and Development Administration (ERDA) and more recently through the Department of Energy (DOE), have been helpful to the industry in developing the technologies, still the most important and supportive step which the federal government has taken to support solar energy was the enactment of the solar tax credits. The solar industry will always be grateful to the members of the Senate Finance Committee and the House Ways and Means Committee and your colleagues in the Congress for your foresight in providing the solar tax credit incentive. It has proved to be the most sound and effective incentive in the marketplace yet known to the solar industry.

You will recall that the Congress first enacted solar tax credits by the passage of the Energy Tax Act of 1978, which provided for a residential credit of 30% of the first $2,000 expended for a qualified solar installation, and 20% of the next $8,000, for a total tax credit of not more than $2,200. For a business installation, which included commercial and industrial installations, the tax credit was 10% of the installed cost of the solar system.

In 1980, the Congress amended the solar tax credits in the provisions of the Windfall Profits Tax Act, so that residential installations received 40% of the installed cost up to $10,000, for a maximum tax credit of $4,000, and for business installations, the tax credit was increased to 15% of the installed cost of the system.

GENERAL VIEWS ON ADMINISTRATION PROPOSAL

SEIA is extremely disappointed that the Administration has chosen now to recommend the repeal of the business energy tax credits for renewable energy.

Not only is this recommendation unwise and unsound economically, but it is also a repudiation of the Administration's firm commitment to the tax credits while justifying the solar budget cuts for FY 1982. Reliance was placed on those statements by the industry and the sudden change of position now by the Administration does damage to the industry, to say nothing for the integrity of the Administration.

SEIA is heartened by the tremendous outpouring of support from the Chairman and Members of this Committee for the retention of the solar tax credits. The letters you have signed, resolutions co-sponsored and public announcements made, have all combined to communicate to the solar industry that the tax credits will be retained and that there is some stability left in federal government energy policy.

We extend our deep appreciation to you for that great showing of support.

Now, we believe you should complete the evaluation and vote to reject the Administration's proposed repeal of the business energy tax credits.

I will now provide the Committee with some sound reasons why this should be done.

SOLAR TAX CREDITS ARE EFFECTIVE

If the Administration's true goal is to eliminate "ineffective subsidies for business," a review is in order because the solar energy tax credit is most definitely not ineffective. A close look by the Administration at what the energy business tax credit has done for promoting solar energy in commercial and industrial structures will quickly show that this particular tax credit is one which has not only provided significant savings for businesses but has also provided savings, and revenues at the federal level.

Numbers have not been made available from the Treasury Department, which would show what percentage of tax credits were taken in 1980 by businesses for incorporating solar. However, if they are reflective of the amount of credits taken in the residential sector, less than 12% of the applicable retail dollar value was taken in tax credtis. Considering most estimates conservatives claim that 22 cents out of each retail dollar spent finds its way back to the federal coffers in the form of personal income tax, corporate taxes, excise taxes, licenses, FICA payments, etc., the Treasury would be hard pressed to say that the business energy tax credit is a revenue deficit.

SOLAR TAX CREDITS GENERATE REVENUE

Quite the contrary, the solar tax credits in general have proven to be a revenue generator for the federal government, both with respect to the money sent to the federal coffers by the normal business cycle, and by the amount of fossil fuels that have been offset by the use of solar. In 1981, 20 million square feet of solar collectors were sold, offsetting at today's prices for oil $32 million in foreign oil purchases which directly improves the U.S. balance of trade deficits for hard goods.

Such contribution can hardly be termed "ineffective". Furthermore, for an Administration that is so supply side conscious, there should be the realization that the cornerstones to successful supply side economics is the encouragement of both capital creative enterprises and high employment enterprises, preferably in an industry sector that is rapidly growing.

Solar is all of these. Solar has been growing at over 25% per year compounded since 1976. It is extremely labor intensive at the jobsite and it is a highly capital creative industry. Capital formation has been generated from the private sector, both in the form of corporate investment as well as indivdual investment through the stock market and venture capitalists.

If the Administration would take the time to evaluate what is actually occuring with commercial applications of solar energy it would surely realize the ability for businesses to expense the burning of fossil fuels is, in effect, a 46% tax credit. For a corporate operating officer to recommend to his/her Board of Directors that a major investment be made in energy conservation and generation equipment such as solar, that officer must be able to justify that initial investment within the internal rate of return boundries for that corporation.

When that corporation can continue to operate as it does today, expensing an item at 46%, an incredibly high rate of return would have to be shown to justify an investment such as solar energy equipment.

The 10% ITC and subsequent 15% energy tax credit which is available do not come close to the 46% expensing level. For solar to be truly effective as an energy choice, parity in price must exist at the business level. Thus, a minimum 40% tax credit for solar coupled with the ITC would allow a parity to exist between solar as an energy choice and fossil fuels. This would allow the operating officers to sell a solar capital improvement project to his/her Board of Directors on the basis of future energy savings coupled with a comparable rate of return on that investment as compared to the present expensing level of fossil fuels.

THE ECONOMICS WILL WORK

This is the type of supply side economics that will work, creating jobs, creating improved operating efficiencies of U.S. plants, thus making U.S. producers a more economically solvent product domestically.

It is incumbent upon the Administration to make these types of evaluations and to stop their myopic pessimism that a tax credit is only nonrealized revenue. For every tax credit dollar supplied for solar energy, other tax revenue is realized back to the federal government, plus the offset of purchases of foreign energy improving the balance of trade goods deficit as well as creating capital for expansion of solar enterprises and providing more jobs.

SOLAR TAX CREDITS SHOULD BE EXPANDED AND EXTENDED

SEIA believes that a better use of the Administration's time and effort in the renewable energy area, would be devising a program by which renewable energy sources can be more fully utilized, especially in the commercial, industrial sector of our economy. Certainly the greatest cost savings can be realized in this area, where growing costs of energy reflects itself in every product and service charge.

This hearing today should really not be about preserving the very modest business energy tax credit of 15%, but rather should be about how these important incentives could be expanded and extended. The 15% tax credit does not provide sufficient leverage for solar to overcome the heavy front-end costs in all cases. SEIA has always supported the position that the business energy tax credits should be increased to be equal to the 40% tax credit now available for residential installation. Indeed, this committee reported a bill in 1980 as part of the Windfall Profits Tax Act that would have provided a more meaningful level for the business energy tax credit. Unfortunately, however, that position was rejected in conference with the House. We are certain, though, that this is the proper course for the government to follow and firmly believe that it will work in the best interests of the industry and the nation in building a more viable source of renewable energy.

As a part of that same policy, it is our position that both the residential and business energy tax credits should be extended beyond their present expiration dates at the end of calendar year 1985, to the end of calendar year 1992. This is especially important in the business planning cycles that some decision be made on this matter fairly soon. The marketing of solar installations in commercial and industrial locations take considerable time and planning. Business moves in planning cycles of 3,5,7 or 10 year cycles and thus it is important that questions about the availability of these tax credits be answered soon regarding the planning period beyond the current expiration date of 1985.

I want to make it clear that none of the foregoing should be taken to mean that solar is looking for a free ride from the federal government. This is not the case and the only request that the solar industry is making is a position of equity and fairness in the case of the tax credits.

Other forms of energy have received generous subsidies from the federal government, both currently and in the past. This policy is right and proper for a government that cares about the energy and economic needs of its people and the free enterprise system by which its economy operates.

However, there comes a time when energy production and usage, like all other segments of the free enterprise system, must stand on its own merits and either succeed or fail on the decisions of the consumers. Solar businessmen and women do not fear that time but seek only a parity position with other energy sources in our country. That time may soon arrive with market conditions bringing it about more rapidly than many predict. But that time has not yet arrived and thus, SEIA is asking that the tax credits be continued, expanded, and extended to complete the job for which the Congress originally enacted them.

CONCLUSION

The only sensible program for the United States today in the energy area is to seek a balanced program of encouragement for all energy forms, including the renewable energy sources. This nation has invested many millions of dollars in the research, development and demonstration of renewable energy sources, but the enactment of the solar tax credits have provided the most sound method for bringing about the marketing of solar devices.

The solar tax credits make good economic sense. The tax credits are having a good effect in moving the market, although they are insufficient in size to bring about any fast movement toward renewable energy sources. The tax credits are actually sources of revenue to the Treasury, not a drain, as has often been perceived.

Rather than this hearing focusing on repealing the small 15% tax credit presently available for business energy purposes, it would make more economic sense to consider expanding and extending the tax credits beyond their present level.

Mr. Chairman, and members of the committee, I appreciate this opportunity to have presented this testimony and pledge the cooperation of SEIA to work with you and the committee staff to be of any further assistance possible as you consider these important matters.

STATEMENT OF MICHAEL KOLEDA, NATIONAL COUNCIL ON SYNTHETIC FUELS PRODUCTION, WASHINGTON, D.C.

Mr. **Koleda**. Mr. Chairman and members of the committee, my name is Michael Koleda and I'm president of the National Council on Synthetic Fuels Production, which is a 51-member company trade association of firms that will be involved in producing synthetic fuels in this country and supplying the industry.

Ironically, it was exactly 5 months ago today that I last appeared before Senator Wallop's Subcommittee on Energy and Agricultural Taxation. At that time the issue was whether to expand coverage of the energy investment tax credit in ways that would provide added incentives to American industry to invest in facilities to produce synthetic fuels. This time, the issue is, instead, whether the energy investment tax credit is necessary at all.

Mr. Chairman and members of the committee, I would just like to spend a couple of minutes telling you a little bit about where the synthetic fuels industry in the United States stands today and what the challenges are.

Three years ago, we had, of course, a doubling of OPEC prices, we had the revolution in Iran, the Russian movement into Afghanistan. We were very unclear about the future of nuclear energy after the Three Mile Island incident. It was clear in the Congress and in the country at large that we had to do a better job of looking ahead a decade or so to assure that we would have in place a system that was necessary to the energy security of our citizens and businesses.

The Energy Security Act, and the provisions of the Tax Code that the Congress put into effect, were designed to help bring the synthetic fuels industry on line by the end of this decade and into the 1990's. And they would enable us to stay the course even if oil prices went flat or perhaps declined in real terms from time to time. In other words, these incentives would enable industry to stay the course.

Today, oil prices are declining in real terms. The real cost of capital is positive for the first time in quite a number of years. All bets are off on long-term investment in American industry across the board, and I know you have been hearing about this in the last several days and weeks. For synfuels projects, it is even worse because synfuels projects have always been at the end of the line in large investment expenditures. They are long term. They are multibillion dollar. They are technologies that have not been put in place. They are high risk. They are not going to happen unless they are somehow brought forward in the line of investment projects through the kinds of incentives that are contained now in the Tax Code, and in the Energy Security Act.

It's important that these incentives remain, particularly in view of the fact that the market timetable already is slowing. There is not a synthetic fuels operation in the United States that is not looking anxiously at oil price projections, that's not reviewing its timetable, that's not in some sense slowing down. It is more important than ever that these incentives be retained if the timetable is going to be kept.

The incentives, Mr. Chairman and members of the committee, were designed to solve a difficult problem. How could Government encourage the development of a synthetic fuels industry and still leave business decisionmaking in private sector hands? How could we stay the course when we knew from time to time that the world picture would encourage industry to slow down?

Those incentives are neutral in that sense. They are perhaps the best mix of incentives that we could design to make the synthetic fuels industry come into being a decade down the line. If we lose them now, I think there is no question that we will have dealt a severe blow to the synthetic fuels industry's timetable.

I don't know what kind of incentives will be considered the next time if energy insecurity once again is brought to the attention of the American people. But I do know that they are unlikely to be as benign in their impact on decisionmaking in the private sector as these incentives that we now have and that we believe we ought to retain.

Thank you.

[The prepared statement follows:]

TESTIMONY OF MICHAEL S. KOLEDA, PRESIDENT, NATIONAL COUNCIL ON SYNTHETIC FUELS PRODUCTION

MR. CHAIRMAN, MY NAME IS MICHAEL KOLEDA AND I AM PRESIDENT OF THE NATIONAL COUNCIL ON SYNTHETIC FUELS PRODUCTION. THE COUNCIL REPRESENTS 51 MEMBER COMPANIES WHO ARE EITHER EQUITY PARTICIPANTS IN SYNTHETIC FUELS PROJECTS, OR WHO WILL SERVE THE INDUSTRY THROUGH PROJECT DESIGN AND CONSTRUCTION, EQUIPMENT MANUFACTURE, RESEARCH AND DEVELOPMENT, OR PROJECT FINANCE. WE APPRECIATE THE OPPORTUNITY TO EXPRESS OUR VIEWS HERE THIS AFTERNOON.

IRONICALLY, IT WAS EXACTLY FIVE MONTHS AGO TODAY -- ON OCTOBER 19, 1981 -- THAT I LAST APPEARED BEFORE SENATOR WALLOP'S SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION WHICH WAS CONSIDERING WHETHER TO EXPAND COVERAGE OF THE ENERGY INVESTMENT TAX CREDIT (EITC) IN WAYS THAT WOULD PROVIDE ADDED INCENTIVES FOR AMERICAN INDUSTRY TO INVEST IN FACILITIES TO PRODUCE SYNTHETIC FUELS. THIS TIME, THE ISSUE INSTEAD IS WHETHER THE ENERGY INVESTMENT TAX CREDIT IS NECESSARY AT ALL -- EVEN IN ITS ORIGINAL FORM.

THIS DEVELOPMENT, I SUPPOSE, COULD LEAD ONE TO CONCLUDE THAT IN JUST FIVE MONTHS' TIME, MARKET FORCES ALONE HAVE MOVED THE NATION'S SYNTHETIC FUELS EFFORTS ALONG SO RAPIDLY THAT TAX INCENTIVES ARE NO LONGER NEEDED. I CAN ASSURE YOU, MR. CHAIRMAN, THAT IS CERTAINLY NOT THE CASE. THE TRUTH IS THAT AS FAR AS THE SYNTHETIC FUELS INDUSTRY IS CONCERNED, THE ENERGY INVESTMENT TAX CREDIT IS NEEDED NOW MORE THAN EVER. AND ON A BROADER SCALE, THE

PASSAGE OF FIVE MONTHS HAS DONE NOTHING TO DIMINISH THE IMPORTANCE OF ENSURING AMERICA'S ACCESS TO RELIABLE SOURCES OF ENERGY IN AN UNCERTAIN FUTURE.

MR. CHAIRMAN, THE NATIONAL COUNCIL ON SYNTHETIC FUELS PRODUCTION OPPOSES THE ADMINISTRATION'S PROPOSAL TO REPEAL THE ENERGY INVESTMENT TAX CREDIT. FURTHERMORE, WE WISH TO REAFFIRM OUR SUPPORT OF PROVISIONS OF S. 750, WHICH IMPROVES THE POTENTIAL FOR THIS CREDIT TO ENCOURAGE SYNTHETIC FUELS PRODUCTION.

WE AT THE COUNCIL SUPPORT A NATIONAL SYNTHETIC FUELS POLICY THAT STRESSES MAXIMUM RELIANCE ON THE PRIVATE SECTOR. THE FEDERAL ROLE IN THIS POLICY HAS TWO ELEMENTS: ONE, THE CONTINGENT FINANCIAL SUPPORT OFFERED BY THE SYNTHETIC FUELS CORPORATION; AND TWO, TAX INCENTIVES THAT ARE DESIGNED TO STIMULATE PRIVATE INVESTMENT IN SYNFUELS PROJECTS.

THE PROFITABILITY OF A SYNTHETIC FUELS PROJECT DEPENDS ON A HOST OF FACTORS -- SOME MORE QUANTIFIABLE THAN OTHERS, SOME MORE PREDICTABLE THAN OTHERS, SOME MORE IMPORTANT THAN OTHERS. OF CRITICAL IMPORTANCE, HOWEVER, IS THAT POINT IN THE LIFE OF A PROJECT WHEN THE SYNTHETIC FUEL PRODUCT CAN BE PRODUCED AND SOLD AT A PRICE COMPETITIVE WITH OIL OR NATURAL GAS. AS THAT "CROSSOVER" DATE COMES CLOSER, THE MARKET INCENTIVE INCREASES TO SHIFT INVESTMENT DOLLARS FROM CONVENTIONAL SUPPLIES DEVELOPMENT TO SYNTHETIC SUPPLIES DEVELOPMENT. IN OTHER WORDS, THE MARKET TIMETABLE FOR SYNTHETIC FUELS PRODUCTION ACCELERATES.

In 1979, following the revolution in Iran, the world price of oil doubled. Oil was selling for ten times its price seven years earlier. There was a fear of further instability in the Middle East. Oil demand was still high. Inflation had eroded the demand-depressing effect of the oil price increases of 1973-74. Three Mile Island threatened the loss of the nuclear energy option. All of this combined to spell continued upward pressure on real oil prices and continued uncertainty of supply.

Since then, economic recession, price-induced energy conservation, and fuel-switching efforts in the oil-importing countries have combined to soften substantially the world oil market. Prices have declined not only in real, but in nominal terms, as well. OPEC seems to have lost its internal desciplime -- an ominous sign for any cartel.

Today, some oil price prophets see stable real prices over the balance of the decade. If you crank that kind of projection into the financial analysis of a multi-billion dollar synfuels project, obviously the "crossover" point recedes. For the nation, that means further delays in developing the commercial synthetic fuels industry that we need.

Simply put, the 10 percent energy investment tax credit brightens the economics of a synthetic fuels project. The energy credit brings a synfuels project forward in the queue of all projects competing for investment dollars. Like higher oil price

PROJECTIONS OR LOWER COSTS OF CAPITAL, THE ENERGY CREDIT ACCELERATES THE MARKET TIMETABLE FOR SYNFUELS DEVELOPMENT.

THE ENERGY CREDIT COULD BE MADE FULLY EFFECTIVE BY THE PASSAGE OF S. 750, TO WHICH I REFERRED EARLIER.

FIRST, S. 750 WOULD AMEND THE SO-CALLED "AFFIRMATIVE COMMITMENT RULE" THAT GOVERNS ELIGIBILITY FOR THE ENERGY CREDIT. TO COMPLY WITH THAT RULE, PROJECT SPONSORS MUST HAVE COMPLETED ALL ENGINEERING STUDIES NECESSARY TO BEGIN CONSTRUCTION, AND ALSO MUST HAVE FILED APPLICATIONS FOR ALL FEDERAL, STATE AND LOCAL ENVIRONMENTAL AND CONSTRUCTION PERMITS BY DECEMBER 31, 1982. IN ADDITION, THE SPONSORS MUST HAVE SIGNED BINDING CONTRACTS FOR ACQUISITION AND CONSTRUCTION INVOLVING AT LEAST 50 PERCENT OF THE COST OF ALL SPECIALLY DESIGNED EQUIPMENT FOR A PROJECT BY DECEMBER 31, 1985.

S. 750 WOULD EXTEND THESE AFFIRMATIVE COMMITMENT DATES. UNLESS THE DATES ARE EXTENDED, FEW PROJECTS WILL QUALIFY FOR THE ENERGY CREDIT BECAUSE OF THE EXTENSIVE TIME REQUIRED TO COMPLETE THE DESIGN AND CONSTRUCTION OF A COMMERCIAL-SCALE SYNTHETIC FUELS PLANT AND BECAUSE OF THE COMPLEXITY, UNCERTAINTY, AND DELAYS IMPOSED BY PERMITTING REQUIREMENTS FOR SUCH PLANTS. PUT ANOTHER WAY, KEEPING THE AFFIRMATIVE COMMITMENT DATES AS THEY ARE WILL HAVE THE SAME EFFECT AS OUTRIGHT REPEAL OF THE ENERGY CREDIT.

SECOND, S. 750 WOULD MODIFY THE SECTION OF THE LAW THAT DEALS WITH "ASSOCIATED PROPERTY". UNDER PRESENT LAW, MANY CATEGORIES OF EQUIPMENT THAT ARE ESSENTIAL AND INTEGRAL PARTS OF A SYNTHETIC FUELS PRODUCTION PLANT HAVE BEEN RULED INELIGIBLE FOR THE TAX CREDIT. THIS ARISES BECAUSE EXISTING STATUTORY RULES DETERMINING ELIGIBILITY OF EQUIPMENT USED IN THE PRODUCTION OF SYNTHETIC FUELS OR SUBSTITUTE FEEDSTOCKS DEFINE SUCH EQUIPMENT BY USING THE PHRASES "EQUIPMENT FOR CONVERTING" AND "EQUIPMENT TO CONVERT." THE INTERNAL REVENUE SERVICE HAS TAKEN AN UNDULY RESTRICTIVE INTERPRETATION OF THESE TWO PHRASES IN ITS REGULATIONS. AS A RESULT, OTHER EQUIPMENT AT A SYNTHETIC FUEL OR SUBSTITUTE FEEDSTOCK PLANT IS EXCLUDED FROM ELIGIBILITY FOR THE ENERGY CREDIT WHERE THE EQUIPMENT IS NOT DIRECTLY IN THE CONVERSION STREAM.

EQUIPMENT MADE INELIGIBLE FOR THE ENERGY CREDIT UNDER THIS INTERPRETATION INCLUDES OXYGEN OR HYDROGEN PLANTS; EQUIPMENT TO RECOVER BY-PRODUCTS; EQUIPMENT TO TREAT OR RECOVER WATER, CATALYSTS OR OTHER REACTANTS USED IN THE PROCESS; EQUIPMENT TO STORE AND TRANSFER BY-PRODUCTS OR END-PRODUCTS AFTER PRODUCTION OR RECOVERY; SPECIAL PURPOSE STRUCTURES TO SUPPORT AND HOUSE QUALIFYING EQUIPMENT; AND EQUIPMENT TO TRANSMIT PROCESS HEAT TO THE ON-STREAM EQUIPMENT OR TO GENERATE AND TRANSMIT ELECTRICITY TO THE ON-STREAM EQUIPMENT. ALL OF THESE TYPES OF EQUIPMENT ARE ESSENTIAL PARTS OF A SYNTHETIC FUEL OR SUBSTITUTE FEEDSTOCK PLANT AND THIS INTERPRETATION OF PRESENT LAW REDUCES THE EFFECTIVE RATE

OF THE ENERGY CREDIT FROM 10 PERCENT TO ONLY 6 TO 8 PERCENT FOR THE TYPICAL COAL CONVERSION FACILITY.

S. 750 WOULD RECTIFY THIS SITUATION BY DEFINING PROPERTY ASSOCIATED WITH ALTERNATIVE ENERGY PROPERTY AS BEING "REASONABLY NECESSARY TO ENABLE THE UTILIZATION OF AN ALTERNATE SUBSTANCE." THIS MERITORIOUS PROPOSAL WILL CLARIFY ELIGIBILITY FOR THE ENERGY CREDIT TO INCLUDE THESE ESSENTIAL PARTS OF THE SYNTHETIC FUEL OR SUBSTITUTE FEEDSTOCK PLANT AND WILL REFLECT WHAT I PERCEIVE TO BE THE ORIGINAL CONGRESSIONAL INTENT OF THE PROVISIONS. FROM A TECHNICAL STANDPOINT, IT ALSO WOULD BE CONSISTENT TO EXTEND THIS ASSOCIATED PROPERTY RULE TO COVER ESSENTIAL EQUIPMENT IN A SHALE OIL FACILITY, INCLUDING THAT NECESSARY TO UPGRADE SHALE OIL TO THE EQUIVALENT OF PETROLEUM.

IN CONCLUSION, MR. CHAIRMAN, THE NATIONAL COUNCIL ON SYNTHETIC FUELS PRODUCTION BELIEVES THAT IT IS CRITICALLY IMPORTANT FOR CONGRESS NOT ONLY TO RETAIN THE ENERGY INVESTMENT TAX CREDIT BUT ALSO TO EXPAND COVERAGE OF THE CREDIT. THE UNITED STATES, THANKS TO YOU IN THE CONGRESS, NOW HAS IN PLACE THE FOUNDATION FOR DEVELOPING A COMMERCIAL SYNTHETIC FUELS INDUSTRY. WE NEED TO BUILD ON THAT FOUNDATION -- NOT TEAR IT DOWN. SYNTHETIC FUELS REPRESENT ONE OF THE BEST INVESTMENTS OUR NATION CAN MAKE TOWARD LESSENING POLITICAL TENSIONS IN THE MIDDLE EAST, TOWARD SHIELDING OUR ECONOMY FROM THE DEBILITATING ROLLERCOASTER OF VIOLENT OIL PRICE SWINGS, AND TOWARD PROTECTING OUR CITIZENS FROM THE CONSEQUENCES OF ENERGY DISRUPTIONS IN THE YEARS AHEAD. THE TRUE BENEFICIARY OF A REPEAL OF THE ENERGY INVESTMENT TAX CREDIT WOULD BE NOT THE U. S. TREASURY BUT INSTEAD THE TREASURIES OF THOSE COUNTRIES WHO STAND TO GAIN FROM OUR CONTINUED DEPENDENCE ON IMPORTED OIL.

STATEMENT, SUZETTE TAPPER, LEGISLATIVE REPRESENTATIVE, SOLAR LOBBY, WASHINGTON, D.C.

Senator **Packwood**. Ms. Tapper.

Ms. **Tapper**. Before I begin, I would also like to thank the members of this committee for the firm support they have shown us and the cooperation in these recent weeks. It is very appreciated.

The Solar Lobby is a citizen's organization. We support what has been said here today generally about the tax credits. But as representative of 45,000 ordinary citizens of the United States, we would like to talk today especially about national energy policy generally. And how this proposal affects it.

The administration has recommended that the credit be revoked, saying that they are "inconsistent with the administration's philosophy of relying on markets to allocate resources efficiently and with its policy to rely on the market rather than Federal management to determine patterns of energy use."

This assumes that whatever costs the consumer the least will be the Nation's best energy choice. We reject this position as naive and virtually irresponsible as a basis for national energy policy. And we are not alone. You have heard quoted this afternoon previously the study of the very conservative Center for Strategic and International Studies of Georgetown University. I would like to read you another passage from that study. In their conclusion, they say:

> In the course of the investigations of this book, we have concluded that the U.S. Government's executive branch's arrangements for coordinating international energy policy are inadequate. The Reagan administration may yet effect a comprehensive program that more fully recognizes areas in which Government must plan a larger role, often in the support of the private sector. Still time passes.

Mr. Chairman, all sources of energy are not equal with the sole exception of price. There are other critical differences among sources of energy which dictate that some are better choices for this country than others. Sources of energy that creates jobs in the United States are more desirable than those that do not. Sources of energy that keep money within our economy are better than those that drain our resources into foreign economies. Sources of energy that don't pollute the environment are better choices than those that do. Sources of energy that we can depend on in a crisis are better than those which are vulnerable to international disruptions. Sources of energy that are not hazardous to health are better than those that are. And, finally, sources of energy that we do not have to defend militarily are better than those that require such a defense.

None of these considerations are adequately expressed by the administration's policy. We must rely upon Congress to prevent such a foolhardy course toward our energy future.

Thank you, Mr. Chairman.

[The prepared statement follows:]

TESTIMONY OF SUZETTE TAPPER, SOLAR LOBBY

SUMMARY

* The Solar Lobby is a membership organization representing 45,00 members.

* We support the business energy tax credits.

* We reject the Administration's policy of relying solely upon price to determine the choice of energy resources.

* That policy ignores: our need for jobs,
 the quality of our environment,
 our vulnerability to energy cut-off,
 the need to keep capital in this country, and
 our national security.

* The free market does not in fact exist because all energy is subsidized by government in one way or another.

* The business energy tax credits, far from being a drain on the Treasury, actually results in a net gain to the Treasury by decreasing fossil fuel expensing.

* This Administration has created an unstable business climate by alternatively promising these tax credits would remain in effect while advocating their repeal. If our economy is to improve it must be a high priority to create a favorable investment climate.

* A current report by the Midwest Govenor's conference demonstrates that econmic growth can come to a halt if sufficient revenue is leaving a region to pay for energy costs.

* It is simply unacceptable for this country to continue to be vulnerable to yet another oil cut-off.

Mr. Chairman, members of the Committee, ladies and gentlemen, I am Suzette Tapper, legislative and tax specialist for the Solar Lobby. I am pleased to have the opportunity to appear before this Committee in support of the retention of the business energy tax credits.

The Solar Lobby is a membership organization based in Washington, D.C., representing over 45,000 small businessmen and solar enthusiasts throughout the United States who believe that an expeditious transition to the use of renewable energy resources combined with aggressive programs fostering energy efficiency is the only basis of a sound energy policy that can enhance security of the United States in the next decade.

Our membership supports the business energy tax credits for renewable energy, not just because the credits are a significant factor in the continued investment and expansion of a domestic renewable energy industry, but because renewable energy is the safest, cheapest, and most plentiful source of energy. Several national polls have shown that the majority of the American public prefers the development of renewable energy options above any other energy option.

The Treasury Department reported on February 26, 1982 that the credits should be revoked because they are "inconsistent with the Administration's philosophy of relying on markets to allocate resources efficiently and with its policy to rely on the market, rather than Federal management to determine patterns of energy use."

This assumes that whatever is cheapest to the consumer today will be the nation's best energy choice. We think there are additional considerations and reject this naive and irresponsible basis for public policy which ignores the following principles that we think should guide our energy choices:

- sources of energy that create jobs in the United States are more desirable than those that don't;
- sources of energy that don't pollute the environment are better than those that do;
- sources of energy that we don't have to defend militarily are better than those requiring such defense;
- sources of energy that keep money within our economy are better than those that drain money to foreign countries;
- renewable energy sources are better than any other energy form that is not produced domestically; and
- renewable energy businesses employ more people per dollar invested than other energy forms.

Because of the benefits to national security, employment, and public health, renewable energy is the first choice in any national energy policy. These credits are the cornerstone to ensure that the private sector is encouraged to integrate this energy source into the United States economy quickly and extensively. Because alcohol fuels, hydroelectric power, solar energy, and wind power are so important to the United States, even in this oil-glutted market, we must maintain a positive investment climate, which has faltered because of the Administration's proposed repeal of these business energy tax credits.

The Solar Lobby would like to point out that all the conventional forms of energy in use in the United States today are subsidized by the U.S. government up to 46 percent. Repeatedly, we have called on the Federal government to give renewable energy its fair share of R & D funds and tax incentives.

We also wish to point out that these tax credits add revenue to the U.S. Treasury. These business energy tax credits will provide a net gain to the Treasury because corporations (most of whom are in the 46-percent bracket) are allowed to deduct the cost of fossil fuels as a business expense, subsequently lowering their taxable income. The Treasury would be increasing revenues every time a business takes the energy tax credits because they would gain income that would have been lost in fuel expensing. The saving to the government increases when fuel prices go up because these businesses would take even greater fuel tax expenses. A study done for DOE by Lawrence Livermore Labs took business tax expensing for fossil fuels into account when projecting the cost of solar tax credits. The study concluded that the current 25 percent composite credit would net the U.S. Treasury approximately $956 million between 1981 and 1990. The Reagan Administration, failing to take into account the revenue loss from fossil fuel expensing, wrongly projected that the repeal of the tax credits in 1983 would yield $100 million to the Treasury.

Another important case for keeping the tax credits involves the mixed signals government gives the private sector. Government cannot keep on changing rules in the middle of the game. This does irreparable harm to businesses who have invested millions of dollars on the basis of government guarantees. In addition, tax credits cause people to make investments that they otherwise would not make. The city of Oceanside, California, raised $20 million in investment capital with which to buy solar equipment to lease to their residents. There is no question that these investors would not have put up their money unless there was a 15 percent energy investment credit.

Another point for the Committee's consideration is that there are no other private tax incentives to help the renewable energy industry. ACRS did not help solar relative to other technologies. In fact, it may have put renewable energy technologies at a serious disadvantage.

Finally, we need the tax credits to help create jobs for Americans and to improve our national security. The Solar Lobby mailed to many Members of Congress a 1981 report from the Midwest Governors Conference that had some startling conclusions.

The report found that: if business as usual continues for the next five years, over $400 billion dollars will leave the region to imported energy; as a result of this major loss of revenue, economic growth could come to a halt and the most labor-intensive industries would be cut by 25 percent. A million jobs could be lost. In contrast, a domestic renewable fuels industry has enormous job-creation potential and could produce revenue for the U.S. Treasury.

Finally, there is no way this country should be at the mercy of another oil cutoff -- whether caused by a cartel, political instability, or natural disaster. The United States must have a renewable resource energy base for its security. The retention of the business energy tax credits is the first step in encouraging the private sector to help us move in this important direction.

The Solar Lobby would like to thank you Mr. Chairman and members of the Committee who have advised the President that these business energy tax credits are vital and need to be kept intact.

Senator PACKWOOD. I have no questions of any of you. I think you know the commitment that most of us in this committee—and especially Senator Matsunaga and I and others—have to alternative energy. You were with us on that struggle that we had when we got the credits increased. And I understand the argument about the disparity between business and residential credits. And I think your argument really is not the disparity between residential and business but between business tax deductions, which they can take annually for fossil fuels, and the credits which are significantly lower. I hope we can get them there.

I asked earlier when the insurance man was testifying, what do you do? And I gave a certain series of circumstances which had to do with the budget. You know what the position of this administration is. Fortunately, most of these credits do not expire this year. I hope we can extend those that do, and the rest of them are by and large 1985 or later.

But when we are talking about people putting in—I don't care if it is a homeowner putting in an $8,000 water heater or whether we are talking about synthetic fuel and hundreds of millions of dollars—people who are going to make investments of that kind want some assurance of longevity. And if there is any single thing the business people have said over the years, in addition to the fact that they don't like taxes—but none of us do—it's uncertainty. That if they knew their tax rate was going to be 60 percent, heaven forbid, for 10 years, they might be able to plan for it. But if you are going to try to get into your business and you don't know if the credits are going to be 10 percent or 20 percent or 30 percent or gone then, by and large, you are probably unwise to get into the business. You cannot afford to make investments on that kind of a basis.

Sparky.

Senator MATSUNAGA. Thank you, Mr. Chairman. I, too, wish to join in expressing my support, as the Senator from Oregon, as a great supporter of renewable energy. And we are very fortunate that on both sides of the aisle we differ with the administration's position.

What I would like to have is some figures to show how much the renewable energy industry has helped the economy improve the employment situation. I mean how many would be unemployed had it not been for the renewable energy development, and new industries created by the development of renewable energy. And what effect it has had on the balance of trade, for example. And whether we are exporting any of the energy which we have started in the area of renewable energy.

And we need some things we can throw at the opponents of continuing the energy tax credit. What we would like to be able to show is by the presentation of figures. By actually providing incentives by way of tax credits, we are, in fact, increasing the revenues to the Federal Treasury, as well as helping to bring our economy back on its feet. So if you can provide us with something like that—I haven't had a chance to go through your full testimony, but some of these things we need to be able to support our position that renewable tax credits should be continued to provide incentives to businessmen who otherwise would never go into the renewable energy business.

I am fully committed to the development of renewable energy. There is so much that can be done. In the short time that Hawaii has undertaken renewable energy and development of its own resources, for example, from 100 percent dependency on imported crude on the big Island of Hawaii, for example, just by burning sugar cane wastes and development of the bagasse. Now they are now producing more than 40 percent of its electricity, which used to be produced 100 percent from crude, by burning of bagasse.

Senator **Packwood**. How long a conversion was that?

Senator **Matsunaga**. Just within a 4-year period.

Senator **Packwood**. That's all?

Senator **Matsunaga**. Yes; and then on the Island of Kauai within a 2-year period, as soon as we passed the tax credit for burning of biomats—providing $3 in tax credit for every barrel of oil saved. You remember we passed that. Well, Kauai—that's my home island—within the period of 2 years developed a system of burning sugar cane bagasse, of separating the bagasse and making them into pellets. And now they are producing 51 percent of its total electricity by burning sugar cane wastes. It used to be 100 percent burning crude. And that's how far we have gone. And then the geothermal will provide as much as 500 megawatts from the one steam well that we have discovered. And all the Federal Government did was to help in the development of one well. These are 3½-megawatt generators. And since we proved the technology, and it was very successful, private industry, on its own, has gone ahead and dug four additional wells at the same site. Each of those wells will be producing about 3 or 3½-megawatts. Some of them are trying to attempt a 5-megawatt generator. So by the initiative, which the Federal Government provided by way of research and development, we have shown the way to the private sector that it can be done.

In the air of OTEC, for example, by helping to prove that the technology is workable, we now have private industry willing to pay as much as 80 percent of the cost of developing a model 40-megawatt plant. But all of these were zeroed out by the present administration. And had it not been for bipartisan support in the Congress, it would have been eliminated altogether.

But you can help us, I think, by providing facts and figures as to just how. Not by just saying this is a good thing. But here are the facts. Had it not been for development of renewable energy, we wouldn't have had 1,000 jobs or 3,000 jobs, whatever the figure is, now employed in the renewable energy field.

I think these are the things that can help us to help you. And by you helping us, we help you, and we help the Nation, I think, to become energy self-sufficient. And when we become energy self-sufficient—and I was hoping to have Hawaii become the first State in the Nation to become fully energy self-sufficient by 1990. We have the target under the previous administration. Now it has been considerably slowed down. But we still feel that from 100 percent dependency on foreign imported oil we can become 100 percent self-sufficient by use of those resources which are indigenous to Hawaii.

Solar energy, jewel thermal energy. Solar, of course, would include wind and OTEC.

And then I was so proud of turning the switch to the first lived-in, solar photovoltaic take powered home on the Island of Molokai. We three haved lived in homes now that are completely powered by solar photovoltaic take valves. And Henry Whipke, a good friend of mine, a retired school principal, whenever he sees me, he thanks me. He says, "Oh, Sparky, I used to pay close to $200 a month for electricity." This is on the Island of Molokai where electricity sells for $0.20 a kilowatt-hour. The most expensive in the United States. And he says that now since you helped me to get the solar system for my home, I not only enjoy free electricity for every use possible in my home, Molokai Electric Co. pays me $20 to $25 every month for the excess produced by my system, which is fed into the Molokai Electric grid.

It's a miracle from his standpoint. And we have three such homes. Two in Honolulu; one in Molokai. And then last January I was on the Island of Kauai, my home island, and I turned on the switch for the solar photovoltaic take system for Wilcox Memorial Hospital. The first hospital in the world to be powered by a solar photovoltaic take system. And we adopted the system there wherein the solar cells are floating in water. And we have convex mirrors to concentrate the light on the solar cells which would heat it up. And while the cells are floating in water—the water is heated up in the same process. So we have electricity and hot water being produced by the same process. And it was a cloudy day and yet 180 percent of the hospital's requirement for hot water was being produced that day.

So much can be done if we make up our minds to do it.

And I thank you for the effort that you have taken toward helping this Nation to become energy self-sufficient, and getting back on its economic feet.

I spoke too long, Mr. Chairman. But I get so worked up about that.

Senator PACKWOOD. I thought Sparky one of the cleverest lobbying devices you had was that photovoltaic music box that when you have it up to the Sun it plays "You Are My Sunshine."

[Laughter.]

I will adjourn the hearing. Thank you very much for coming.

[Whereupon, at 3:10 p.m., the hearing was adjourned.]

[By direction of the chairman the following communications were made a part of the hearing record:]

STATEMENT OF
THE AMERICAN PAPER INSTITUTE
TO THE SENATE COMMITTEE ON FINANCE, MARCH 19, 1982

The American Paper Institute (API) welcomes the opportunity to comment on the President's tax policies.

API has over 175 members which provide more than 90% of the pulp, paper and paperboard manufactured in this country. Paper and allied products rank among the ten largest industries in the United States with revenues close to $80 billion.

The Economic Recovery Tax Act (ERTA) of 1981 was passed to encourage savings and investment and provide a base for increasing the efficiency of U.S. industry while promoting growth. These basic requirements remain in the system. The current recession only confirms the need to pursue fiscal policies that encourage economic growth. The tax program is relatively new and must be given time to show its effectiveness.

Consequently, we urge the Senate Finance Committee to keep in place the savings and investment incentives which formed the basis for the ERTA.

The pulp, paper and paperboard industry is one of the most capital intensive in the United States. Its capital outlays this year will be close to $7 billion; we project its annual capital needs at $12.5 billion a year in the years 1985-1990. If the industry is to meet the potential needs of both the domestic and international markets in those years, it must make investment decisions now. API estimates that the accelerated capital recovery provisions that are part of the Economic Recovery Tax Act of 1981 will contribute an additional $1 billion a year to the industry's internal funding of capital requirements in 1985-1990.

The incentives provided in ERTA are only now beginning to work. To alter them would compound the effects of recession and cause more delays in capital projects.

The news that business is scaling back some capital spending plans may lead to the mistaken conclusion that the capital incentive program is not working.

The real factor behind the curtailment in capital expenditures is reduced profits which in part reflects high interest rates and the fact that, in the early stages of disinflation, prices move down faster than costs. Removing or postponing incentives now would only hurt.

NEED FOR STABILITY

Business and individuals cannot make long range savings and investment plans if the rules of the game are constantly changing. The long term investment decisions of U.S. business and individuals have been impaired since the early 1970's by the stop-and-go policies of the government. The present discussion of taxes is yet another example of the tendency of government to neglect the need for stability in creating the proper climate for long-term investment decisions. Consequently, we believe it would be harmful to make any major changes in the tax provisions that have already been enacted.

THE DEFICITS PROBLEM

Members of the American Paper Institute are mindful of the problems with the President's budget message which projects sizeable deficits continuing into 1987. This prospect is alarming to all of us. It does contribute to the unnecessarily high interest rates prevalent today. Here are some factors that need to be considered in evaluating this problem.

1. The higher deficits projected in 1983's budget compared with last year's estimate result almost entirely from recession induced factors:
    a) revenues in fiscal 1983 are projected $51 billion lower because of a lower forecast of dollar values of GNP and inflation;
    b) higher unemployment adds $8 billion to the expected outlays for 1983;
    c) higher interest payment and debt contribute another $31 billion to projected outlays for fiscal 1983.

Consequently, the solution must be one that fosters and contributes to faster growth. This clearly indicates that tax policies must be carefully evaluated at this time to ensure that growth is not hindered by tax changes or that the recession be lengthened.

2. Notable progress in spending cuts was made in 1981, but follow-up actions are needed in 1982. Congressional committees have not, to date, seriously come to grips with the need to reduce the rate of advance in government outlays. There are no indications, however crude, that a spending figure approximating the President's total is close at hand. We believe everyone, consumers as well as investors, would be encouraged if at least some progress toward a curtailed rate of government spending could be made now, whatever the mix. This could change the expectation component in interest rates. The pressing problems of entitlement programs may not lend themselves to adequate and fair solutions in the present crisis atmosphere. Long range and permanent solutions are needed for the chronic problems associated with these programs. Real and credible progress on these issues, however small, in the present session of Congress will convince investors that the nation is on the right track.

3. Savings have increased since the first small stage of tax cuts for individuals went into effect on October 1, 1981. A second stage of the tax cut particularly conducive to traditional savings outlets went into effect only on January 1, 1982, when the maximum rate on investment income dropped from 70% to 50% and the new provisions for Individual Retirement Accounts were introduced. These tax initiatives have in part been blunted by the recession; their positive impact should not be minimized by this temporary situation.

   The third stage, to take effect on July 1, 1982, should show an even more convincing response of savings to taxes. A significant change in the present tax policy now would be a premature judgment of the existing one.

Yes, it is taking time, but the failures are not in the program but rather in those forecasters who overstated i's impact.

CURRENT BUSINESS TAX INCREASE PROPOSALS

The Administration has proposed a number of tax increases, under headings such as "Selected Tax Revisions" and "Improved Tax Collection and Enforcement." Included in these proposals are the "revenue enhancing" measures outlined in September, plus some additional increases.

Our support of the President's tax program includes necessary selective tax revisions and changes designed to eliminate abuses and correct unintended loopholes.

The problem is that the provisions affecting industry, in the aggregate, would take back as much as 50% of the corporate tax reductions provided by Economic Recovery Tax Act of 1981 (the corporate tax reduction in the ERTA amounted to only about 20% of the total estimated cut).

Our specific comments on the Administration proposals point up some problems.

Minimium Tax

The minimum tax concept has the potential of seriously impairing the effectiveness of the investment incentives already in place and could have long range detrimental effects on capital formation. These incentives which are designed to speed up the rate of new capital formation are needed if industry is to increase its stock of capital goods more rapidly in the years ahead than in the previous decade.

Energy Credits

Our industry's record on energy conservation resulting from accelerated investment in energy conservation facilities has justified its use of energy tax credits under existing legislation, which includes a sunset provision with appropriate transition rules. The Treasury Department, however, has proposed a restrictive transition rule as part of its repeal of all business energy tax credits, effective January 1, 1983. We cannot support this new rule which would in effect impose retroactive penalties on taxpayers who have relied on existing law and transition rules.

Tax Exempt Bonds

We urge that tax exempt bonds continue to be available for pollution control financing and that facilities so financed continue to qualify for accelerated depreciation. Our industry has made excellent gains in reducing environmental pollution; use of tax exempt bonds for financing mandated, non-revenue raising pollution control facilities has been a key factor is this progress.

Safe Harbor Leasing

The flexibility provided by safe harbor leasing is an essential element of equity in the accelerated cost recovery system. The industry supports its use, particularly for capital intensive industries like ours, which have temporary earnings situations that prevent it from otherwise taking advantage of the investment incentives provided by the Economic Recovery Tax Act of 1981.

The public evaluation of safe harbor leasing stresses the benefit to companies with earnings, while minimizing - and even ignoring - the capital spending benefits to those companies experiencing temporary reductions in cash flow. Forest product producers, who operate in both the housing and paper industries, are a good case in point. Their building product earnings have been hard hit by the slump in housing and yet they find a need to continue to spend in the paper segment of the business. The leasing arrangements have helped some of them miminize the adverse effect of reduced overall cash flow on the required investments in new paper capacity. Clearly, without flexibility, this interim adaptation would not be possible. We therefore urge that these benefits be fully evaluated in assessing the future rules relating to safe harbor leasing or some other form of flexibility.

Accelerated Tax Payments

One element of the proposal to accelerate corporate income tax payments is troublesome. This proposal would increase the required estimated tax payments from 80% to 90% of the current year's tax liability and would impose a severe penalty for underpayment. Compliance within a narrow 10% range would be extremely difficult. Estimates of annual operating earnings, tax depreciation and investment tax credits are educated guesses in the earlier portion of the year. Even post year-end decisions, such as those relating to pension expense deductions, could result in an inaccurate estimate of the tax liability during the tax year.

In summary, progress on federal spending restraint is the most significant need in business expectations; selective revenue enhancing proposals are also needed.

We see no immediate danger to the economy or to inflation from deficits in 1982 and in 1983. Beyond that, the balance will be determined by events that cannot be foreseen at present. Very difficult decisions must be made on the spending side. If they require more time for review and consensus than now exists, Congress ought to at least address the matter of achieving spending targets close to those established by the Administration as a first step. Additional cuts can be made later.

To raise taxes now would signal that Congress cannot discipline itself to do what the public seems to want and that is spending control and reduced taxes.

STATEMENT OF

ASSOCIATED BUILDERS AND CONTRACTORS

BEFORE THE

SENATE FINANCE COMMITTEE
CONCERNING THE ADMINISTRATION'S PROPOSAL TO REPEAL THE COMPLETED CONTRACT METHOD OF ACCOUNTING

Associated Builders and Contractors (ABC) is a national construction industry trade association representing 17,000 firms nationwide. The members of ABC believe in the "merit shop" philosophy, a concept which calls for open competitive bidding with contract award to the lowest responsible bidder. We thank the committee for this opportunity to present our views concerning the Administration's revenue proposal in the FY 1983 budget to eliminate the completed contract method of accounting for income tax reporting.

Associated Builders and Contractors opposes the Administration's proposal to eliminate the completed contract method. Such a proposal would be devastating to the construction industry and the national economy, having both fiscal and monetary effects. We would briefly like to summarize the proposal, explain the concerns and unique features of the construction industry, and describe the impact of the proposal on the industry and the economy.

The Proposal

The Administration's legislative proposal would repeal the completed contract method and provide that taxpayers must elect to use either the percentage of completion method or the progress payment method of accounting for long-term contracts. In addition, the cash and accrual methods could no longer be used. Elimination of the cash and accrual methods from use by the construction industry appears to be arbitrary and punitive since they will still be available to other taxpayers.

The percentage of completion method is a most complicated and uncertain manner for reporting income due to the inability to accurately estimate income on a construction project. The taxpayer must compute the ratio of costs incurred to date over estimated costs for the entire contract. This method would tax excess billings but would not allow an offset for excess costs. Advance and mobilization payments are the rule, not the exception, in the construction industry and are used for purposes which do not result in offsetting tax deductions due to the type of expense for which the cash is used, e.g. collateral for lines of credit. Therefore, this method is not appropriate for the construction industry since early revenues are not proportional to offsetting expenses; and, the difficulty in calculating estimated profit until a construction project is completed is immense.

The progress payment method would be a new means for reporting taxable income. This method would tax positive cash flow independent of any reference to concurrent liabilities. Interim progress payments would be taxed as income, yet they include little or no profit and do not relate to the cost of the work performed because of various cash flow management practices unique to the construction industry.

We feel that the proposed progress payment method is flawed since it would tax recepits when, in fact, no income had been earned. It would treat each contract as a separate entity, requiring the payment of taxes on contracts with positive cash flow while disallowing a reduction in taxes for contracts with negative cash flow, causing a severe financial drain on most of our members.

In addition to the Administration's legislative proposal, the current tax regulations for accounting for long-term contracts would be amended as follows:

- To require that, in the case of contracts accounted for by the completed contract method, all but a limited lists of indirect costs would be allocated to long-term contracts and deferred until such contracts are completed.
- To clarify when an agreement, or series of agreements, should be regarded as more than one contract.
- To specify that, where the taxpayer uses the accrual shipment and accrual acceptance methods of accounting for multi-unit contracts, income accrues upon the shipment or acceptance of various units and not upon the final unit.
- To require that, where the taxpayer is entitled to use an inventory method for a long-term contract, such taxpayer must use the costing rules set forth in the completed contract regulations.

The regulatory changes most affecting the construction industry are those affecting the allocation of indirect costs. In 1976, the Treasury Department made an equitable and appropriate decision on which indirect costs could be considered as "period costs" and deducted currently. A wholesale revision of the period cost deductions is not necessary or warranted.

Revision of the period costs, as proposed in Treasury's technical explanation, would not reflect the realities of the construction industry. Many of these expenses simply do not contribute to the performance of a particular contract but relate to the firm's business expenses as a whole. Certain common expenses cannot be attributed to particular contracts or even be allocated to long term contracts by percentage or formula. Such a practice would prove to be arbitrary and be an accounting nightmare. Interest, general and administrative expenses, and accelerated depreciation are three of the major costs which are impossible to allocate to given long-term contracts since they are used for general working capital and purchase of thousands of pieces of equipment that may be applied to a variety of projects.

Costly record-keeping and paperwork burdens and accounting and legal fees will be incurred by the taxpayers, most of whom are small construction businesses with already narrow profit margins. It is simply not fair that the construction industry should bear this drastic change when it has maintained a consistent tax accounting method for 64 years. If other industries or other period costs are undermining this method of taxation, then they should be addressed specifically.

Concerns and Uniqueness of the Construction Industry

The construction industry has been permitted the use of the completed contract method of accounting since the implementation of the federal income tax in 1918. Distortions in the use of the completed contract method are not evident in the construction industry. The distortions that are evident by other users of the method could be limited by providing a basis for severing long-term production contracts by units of delivery and acceptance or a similar arrangement, without simultaneously penalizing the construction industry's use of the method. The method was designed for the unique aspects of the construction industry.

To require the payment of taxes on contracts with positive cash flow while disallowing a reduction in taxes for contracts with negative cash flow is not only discriminatory against the construction industry but deviates from all traditional theories of business entity taxation (i.e. taxation of profits without any reference to concurrent liabilities). Furthermore, the explanation are based on erroneous assumptions. Such payments are subject to repayment by reduced progress payments during the term of the contract. These payments are not to be considered income, and taxing contract advances is tantamount to taxing working capital loans.

Cash flow is most important for contractors because of the working capital demands of on-going projects, i.e. material, labor and equipment. As a result, the construction industry has become reliant upon the completed contract method for the use of working capital to overcome constraints on their liquid assets inherent in construction industry practices. In addition, contractors' liquidity is most important in their pursuit of new work since it is reflected in the net assets which determines the firms' bonding capacity. Another strain on the contractors' cash flow management, unique to the construction industry, is the practice of retainage. Virtually all construction contracts have retainage provisions which normally withhold ten percent of the portion of the contract price, completed to date, until after project completion. Consequently, the profit element, of which the retainage normally makes up a large part, is not received or realized until retainage is released. Furthermore, the contractor is losing interest on the amount being retained by the payor, further decreasing his profitability. This constraining element is a key factor in demonstrating how important maximum cash flow is to the construction industry. Yet, elimination of the completed contract method would tax, not profits, but this positive cash flow so vital to the contractor.

Other physical and variable risks unique to the construction industry are: differing site and soil conditions, climate conditions, firms prices for the duration of the contract which require the contractor to bind himself to an unalterable price before actual costs are known, changes, modifications or claims during the course of the contract which require the contractor to expend large sums in advance of his contractual right to collect from the owner, intense competition within the industry which forces profit margins to be exceedingly small in relation to the total gross contract amount, and many others.

Given these risks, the construction contractor cannot determine his actual profit until completion of the particular contract. It would be unfair to have a progress payment method which taxes the very cash flow the contractor may need to complete the contract in order to recoup his losses or obtain final payments.

Bonding is a requirement that limits contractors to work on projects only up to the amount of their net assets in order to ensure adequate performance. This is another feature unique to the construction industry. A bonding company considers net worth and working capital in determining the amount of work a contractor can perform. The bonding company also considers deferred taxes not be be paid in the current year as a reduction in current liabilities, therefore increasing working capital. Therefore, the elimination of the completed contract method would have drastic reductions in the contractors' working capital and net assets used to determine their bonding capacity. The effect would be a severe reduction in the amount of work a business could pursue. Some of our members have indicated that elimination of the completed contract method would reduce their bonding capacity by as much as 50 percent.

Use of the progress payment method would create a greater tax liability and vast increases in borrowing. It would result in increased bankruptcies and increased operating costs for surviving firms. The proposed progress payment method would create an immense administrative burden, necessitating the creation of an entirely new set of books for tax purposes. The increased bankruptcies, resulting from increased borrowing, and reduction in bonding capacities will cut the competition throughout the construction industry. This would have a grim effect on the national economy.

Impact on the Industry and the National Economy

We have already mentioned several impacts on the construction industry which would emanate from the elimination of the completed contract method of accounting. There would be a definite negative ripple effect on the national economy. The proposal would create both fiscal and monetary problems which this nation cannot afford.

The primary reason for the Administration's proposal to repeal the completed contract method is the theory that this proposal will produce substantial new federal revenues. However, actual revenues generated would be much lower than currently anticipated. In fact, it is likely that the federal government would lose net tax revenue and probably incur billions of dollars in additional expenditures as a result of this proposal.

There are many factors, which I will soon discuss, which would lead to further unemployment in the construction industry -- a sector which already has an unemployment rate in excess of 18 percent. Federal outlays for unemployment compensation would escalate as more construction firms go out of business or drastically reduce their scope of business. Bankruptcies of construction firms cause economic burdens on suppliers and creditors, who must absorb such losses, and on the federal government, which faces costs in excess of 20 billion dollars for every one percent increase in unemployment.

Federal revenues would actually be lost from the increased tax deductions for interest payments from increased borrowing. Elimination of the completed contract method would force contractors to borrow in order to finance operations formerly financed by tax deferred liabilities and advanced payments. In some cases, firms additional borrowing needs plus interest costs would increase their current operating costs by more than 100 percent. The compounded costs of additional borrowing, additional taxes, and higher interest rates will surely drive marginally profitable small contractors into bankruptcy, decreasing the national tax base.

Increases in borrowing by the construction industry, of the magnitude being discussed at today's high interest rates, would have a staggering impact on our financial markets. The projected demand for short and long term loans to finance operations would definitely exert an upward pressure on interest rates. Higher interest rates would have a tendency to increase bankruptcies, stimulate unemployment, and increase construction costs for those remaining contractors.

The elimination of the completed contract method would result in greater federal expenditures through increased costs for direct federal and federally-assisted construction projects. Increased costs would affect private construction as well and have a definite inflationary trend on the general economy. Increased construction costs would result from: higher interest rates generated by increased borrowing to cover working capital and deferred tax decreases, and less competition, created by increased bankruptcies and firms having reduced bonding capacity due to lower net assets. It is only natural for firms with limited capital resources to increase their prices, or pass such costs on the consumers, when faced with increased debt and expensive financing of that debt.

Higher interest rates, higher unemployment, higher federal deficits, and less competition are the key components of a weak economy. Repeal of the completed contract method of accounting would create all of these conditions. We ask you, how can you produce a vibrant and growing economy when faced with these obstacles? The Administration is in error when it thinks the completed contract method simply defers taxes for construction firms. Eliminating this method would make all taxpayers bear the burden for depriving this capital-intensive industry of the very lifeline of its existence. Eliminating the completed contract method would smother new business starts, strangle small contractors already hurt by the recession, and stagnate the economy with inflationary and higher deficit trends.

Mr. Chairman, I respectfully request that you consider the plight of the construction industry and its unique risks and capital requirements before you act on this devastating "revenue" proposal. Associated Builders and Contractors strongly urges the Administration and the Congress to retain the completed contract method of accounting with regard to long term construction contracts.

Thank you.

WRITTEN STATEMENT OF
DONALD R. KENDALL, JR., VICE PRESIDENT
MORGAN STANLEY & CO. INCORPORATED
Before the
COMMITTEE ON FINANCE
UNITED STATES SENATE
On
THE SPECIAL RULES FOR LEASES
Under the
ECONOMIC RECOVERY TAX ACT OF 1981
March 16-19, 1982

Mr. Chairman and Members of the Committee on Finance:

We are pleased to have this opportunity to provide some of our thoughts on the special rules for leases under the Economic Recovery Tax Act of 1981 ("ERTA"). Morgan Stanley & Co. Incorporated, an investment banking firm, has been active in arranging leases under the leasing guidelines and provisions of the prior law as well as under the new special leasing rules of ERTA. We offer our testimony because we believe that the regulatory and legislative uncertainties which affect tax benefit transfers and safe harbor leasing today are having a disruptive influence on capital formation in our country. Such uncertainty has become a specter that has come to haunt leasing and stifle business activity in this time of high unemployment, soaring interest rates and volatile capital markets. It is for this reason that we appeal to you for speedy clarificaton of the leasing rules.

Uncertainty with Respect to Safe Harbor Leasing

The safe harbor rules for leasing have been fraught with regulatory and legislative uncertainty since their passage on August 13, 1981. These uncertainties, which we outline below, have diminished the effectiveness of safe harbor leasing in increasing capital formation.

For companies to plan and make capital expenditures they need to know the after-tax cost of investing in an asset as well as its expected revenues. The after-tax cost is significantly impacted by a company's ability to use tax incentives such as depreciation and investment tax credit. ERTA significantly increased the present value of the depreciation deductions on most capital assets. Many companies, however, found themselves in a tax position where they could not currently benefit from these additional tax incentives. The special rules for leases provide a mechanism for such companies to benefit immediately from these tax incentives by selling such benefits to another company without giving up the residual value of the equipment and without regard to the type of equipment.

ERTA gave the Department of the Treasury broad leeway in drafting regulations which would dictate the operating procedures for leases under the new law. However, the Treasury has not acted in a manner which mitigates the problem of uncertainty in the leasing market. The Treasury did not provide temporary regulations until October 20, 1981, over two months after passage of ERTA and only three weeks before the retroactive period expired. Prior to the issuance of these temporary regulations, a number of contradictory reports came out of the Treasury which made it difficult to know what the operating rules would be. The temporary regulations did not comment on a number of important areas (e.g., retirement and casualties, investment tax credit pass-through leases, leases between related parties, etc.) and left credit risk a major issue. On November 10, 1981, three days prior to the expiration of the retroactive period, the Treasury amended the temporary regulations in order to provide further clarification and to significantly lessen the credit risk associated with a tax benefit transfer transaction. As of March 10, 1982 final regulations still have not been issued by the Treasury.

Furthermore, uncertainty with respect to the Treasury's temporary and yet-to-be-released final regulations has made and continues to make negotiating and documenting safe harbor leases more difficult and problematic than it otherwise might be. Such difficulties impact companies' use of these provisions and their ability to plan and make future capital commitments.

In addition to the regulatory ambiguities, legislative attacks on tax benefit transfers have contributed to the uncertainty regarding the leasing environment. Even during 1981, legislation was introduced in Congress to repeal the safe harbor leasing rules. At that point, it was clear that insufficient time had passed to determine whether the leasing provisions would aid the intended increase in capital formation. These early indications in Congress regarding the potential repeal of these provisions, as well as speculation in the press, created a great deal of confusion with respect to the longevity of the special rules for leases in general and tax benefit transfers in particular. This uncertainty impacts a company's capital expenditure decisions in a negative fashion.

Most of the leasing activity in 1981 under the special rules for leases was for capital expenditures already made or committed to at the time of the passage of ERTA. These retroactive transactions benefited many companies and gave management an idea of how much they could receive for their tax benefits but such benefits probably only indirectly impacted their plans for future capital expenditures. For companies which had completed transactions and those considering leasing the key question became -- will the special rules for leasing survive and can we count on the leasing benefits for our future capital expenditures?

Senator Robert J. Dole's press release advocating the modification or repeal of the safe harbor leasing provisions as of February 19, 1982 has created further legislative uncertainty. Businesses are uncertain as to whether they should move forward quickly or wait for further clarification. If the rules are repealed any further efforts will have been a costly use of valuable management time. However, if the provisions are not repealed, sellers of tax benefits who have waited for clarification may miss the opportunity to sell tax benefits on certain capital expenditures. Additionally, in many transactions that close after

February 19, 1982, the proceeds received by the sellers will be reduced due to the possibility of modification or repeal of the leasing provisions.

As a result of the numerous factors creating uncertainty with respect to the special rules for leases, few companies are able to plan their capital expenditure programs based on the benefits of tax benefit transfers being available to them. Since companies cannot factor the benefits of these tax incentives into the capital expenditure decision making process, the size and timing of their capital expenditure programs may be impacted in a detrimental fashion.

Efficiency of Safe Harbor Leasing in Transferring Tax Benefits

Safe harbor leases and tax benefit transfers have proved to be relatively efficient vehicles for transferring tax benefits. Tax benefit transfers work well because they are the purest form of tax incentive transfer. There is no need for either party to be concerned with the residual value of the asset at the end of the lease term because the lessee (seller) can keep the asset. There also need be no economic return to the lessor (buyer) other than the tax benefits inherent in the transaction. In addition, the lessee can finance the remainder of the asset's cost in any manner it chooses. If the lessee can use the tax deductions provided over time from the lease payments, tax benefit transfers effectively pass through most of the value of the tax incentives to the lessee. From a present value standpoint the lessee is significantly better off than if it is only able to carry forward the tax benefits of ownership and use them sometime in the future.

Use of Safe Harbor Leasing by Small Business and Start-Up Ventures

Small business and start-up ventures have been able to sell tax benefits through tax benefit transfers and safe harbor leases. The uncertainties outlined herein, however, have made it more difficult for small business to take advantage of the leasing provisions. As in any new developing market, the smaller transactions at first receive less attention but are readily focused on as the market develops and grows. The small transactions are also less visible to the marketplace and as a result often receive less attention in the press. This is the case for tax benefit transfers for small business.

The Department of the Treasury has indicated that of the nearly 16,500 information returns filed with the Internal Revenue Service through February 19, 1982, only 1,217 represent lease transactions involving more than $10 million in leased property. Over 85% of all safe harbor leases involve property costing less than $100,000.

As the market for tax benefits continues to develop, more and more lessors are considering transactions with small businesses and certain financial institutions are packaging small transactions to make them more marketable. We believe that tax benefit transfers are being widely used by small business and would be used even more if uncertainties surrounding the at-risk rules were reduced.

Modification of the Safe Harbor Leasing Rules

If modification of the safe harbor leasing rules is chosen by Congress over outright repeal, we feel that a number of provisions should be retained to increase the efficiency of leasing as an incentive for capital formation. The most restrictive and unfair provision of the existing leveraged leasing guidelines (Rev. Proc. 75-21, 75-28, 76-30 and 79-48) is the requirement to have only a fair market value purchase option at the time of expiration of the lease. This provision has forced lessees and lessors to become experts on residual value and in inflationary environments has proved extremely costly to lessees. The "limited use" provision, which permits only the leasing of assets that can be used by parties other than the original user, is another example of an unfair guideline. This frequently is a subjective definitional test and directs leasing's advantage to only those companies using readily transferable assets.

* *

We believe that the current legislative uncertainty surrounding tax benefit transfers and safe harbor leasing is disruptive to capital formation in this country. We recommend that Congress work quickly to clarify the leasing provisions of ERTA so that companies can conduct their normal business operations, plan their capital expenditure programs and make capital investments with certain knowledge as to the tax incentives that will be available. In addition, if the special rules for leases are modified, we believe that at a minimum both fixed price purchase options and the leasing of "limited use" property should be permitted.

NATIONAL SECURITY INDUSTRIAL ASSOCIATION
National Headquarters

1015 15th Street, N.W.
Suite 901
Washington, D.C. 20005
Telephone: (202) 393-3620

R. S. Ames
Chairman,
Board of Trustees

L. J. Adams
Vice Chairman
Board of Trustees
Chairman
Executive Committee

W. H. Robinson
President

18 March 1982

The Honorable
Robert Dole
Chairman, Committee
on Finance
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

We understand that the Senate Committee on Finance is conducting hearings on the Administration's tax proposals. We wish to comment on an Administration proposal that would alter both current legislation and the tax regulations affecting accounting for long-term contracts. We would appreciate the inclusion of these comments on this matter as part of the record of the hearings.

The National Security Industrial Association (NSIA) is a national organization of more than 300 manufacturing, research and service companies of all sizes and from all segments of industry interested in and related to our nation's security. NSIA serves essentially as a two way communication medium between government - primarily defense - and the industry which supports it. Although a non-lobby organization, this Association often provides its views, in the national interest, on matters being considered by committees of the Congress which have impact on the national defense and its industrial base.

The proposed change in legislation would eliminate both the completed contract method of accounting and the accrual shipment/accrual acceptance method as well as modify period cost recognition while the proposed changes in tax regulations would affect the manner in which the permitted accounting methods are used. We understand that the Administration's intent is to enhance tax revenues and at the same time eliminate perceived tax abuses.

It is our view that the changes proposed would have an overall long-range adverse effect on the cost of weapons systems, readiness of the armed forces and on the overall strength of the nation's defense industrial base.

If Treasury's estimates are accurate, the proposed regulatory initiatives changing the implementation of accounting methods could achieve some of the objectives of the Administration in enhancing tax revenues. However, the proposed changes would at the same time have a significant impact on the tax burden of defense contractors.

The legislative initiative would provide questionable results and would be disruptive and administratively expensive. We believe final action on the legislative initiative should be taken only if proven justifiable after thorough research to determine if the change would have more than a minimal impact. We are greatly concerned that the legislative proposal will create additional administrative cost for government and industry, disrupt long-range planning, and create significant uncertainty in the defense industry at a time when the concerted effort of the industry is particularly needed to accomplish the proposed defense program.

The legislative initiative is to eliminate for long-term contract tax accounting both the completed contract method of reporting revenue and the currently acceptable accrual shipment/accrual acceptance method. As you are probably aware, the completed contract method of accounting has been used for tax accounting for long-term construction contracts since 1918. It was proposed for use by manufacturers operating under long-term contracts in the early 1970's primarily as a reasonable compromise position to reduce or eliminate the continuing arguments over estimates of the percentage of contract completion, market values of contract work-in-process inventories, and the higher initial production cost often incurred in defense contracts. For the most part the completed contract method of accounting eliminates these problems - although Treasury has expressed the concern that other problems have been created. We wish to also point out that every contractor, before converting to the completed contract method of tax accounting, received approval from the IRS.

The accrual shipment/accrual acceptance method requires that costs of production be charged against revenue generated upon delivery or acceptance of completed items. Therefore, taxable income or loss is recognized at that time. Progress payments occurring on such a contract would not result in taxable income since, by regulation, progress payments cannot exceed costs actually incurred. In view of this, we believe there is no justification for eliminating the accrual shipment/accrual acceptance method of accounting for taxable income.

The legislative changes will provide only two methods, the existing percentage of completion method and a new progress payment method. As we understand the new progress payment method proposed by Treasury, progress payments and payments for units shipped would be recorded as revenue when received and be off-set by related deductable costs in determining taxable income. Treasury states that "the completed contract method permits income to be deferred for tax purposes long after payments are received and long after income is deemed earned according to standard accounting practices." While this may be true for some industries, progress payments for long-term defense contracts currently cover only a portion of costs. In addition, reimbursement for units delivered during the life of a contract generally would be based on average unit price. For most defense contracts the cost of producing the first units is higher than the cost of later unit production. Therefore, the average defense contract generally would not produce revenue in excess of cost until the contract is 75 to 80 percent complete.

This modest change in revenue recognition (recognizing cost at the 75 to 80 percent completion point rather than the 100 percent point as under the completed contract method) alone will not produce any increase in tax revenue in the near term and would probably provide only modest revenue increases in the long term. Therefore, we believe the expected modest increase in tax revenue from this legislative change does not justify the extensive effort (in addition to its adverse effects) required to make the change.

The legislative proposal also substantively changes the rules for identifying incurred costs which are subject to being deducted from income in the taxable year incurred (period costs) as opposed to being allocated to an applicable long-term contract and being deductible at a later time. The IRS offers only a cursory reason for this change, i.e., that income is being deferred for tax purposes long after payments are received and income is earned in accordance with generally accepted accounting practices. Although this reason seems to support the Treasury proposal to eliminate the completed contract method, we fail to see its connection to their proposal to redefine period costs. The result of this proposal is to defer deductibility of period costs for tax purposes until revenue has been recognized without regard to whether that revenue is only an accrual rather than a receipt of a payment. Therefore, the proposal is neither good accounting nor good tax policy because it deviates from generally accepted accounting procedures for the sole purpose of enhancing revenue.

In addition, most manufacturers other than those performing under long-term contracts can use the accrual method without inventorying period cost. The ability to use the accrual method and deduct period cost is proposed to be denied manufacturers performing long-term contracts. To deny these taxpayers the methods available to other taxpayers and at the same time to deny them the completed contract method is inequitable and unduly focusses on defense industry before fully assessing the long-range adverse effects on that industry. We believe it is an unwise proposal for the Administration to make.

The National Security Industrial Association (NSIA), as a very long-term and major voice of defense industry, has volunteered to work with the Administration in examining necessary regulatory changes to achieve proper tax accounting objectives. However, we believe any continued legislative effort to eliminate the completed contract method and to change the treatment of period costs is unproductive and possibly counterproductive to the Administration's objectives of enhancing tax revenues and reducing or eliminating perceived tax abuses.

We feel that all positive action possible should be taken with a view to long-term strengthening of the industrial base and controlling the costs of military systems and supplies. We believe the proposed actions are counter to these objectives.

Sincerely,

Wallace H. Robinson, Jr.
President

WHR/LHB/md

STATEMENT OF NORMA PACE, SENIOR VICE PRESIDENT OF THE AMERICAN PAPER INSTITUTE, BEFORE THE SENATE COMMITTEE ON FINANCE, MARCH 18, 1982

The American Paper Institute (API) welcomes the opportunity to comment on the President's tax policies.

API has over 175 members which provide more than 90% of the pulp, paper and paperboard manufactured in this country. Paper and allied products rank among the ten largest industries in the United States with revenues close to $80 billion.

The Economic Recovery Tax Act (ERTA) of 1981 was passed to encourage savings and investment and provide a base for increasing the efficiency of U.S. industry while promoting growth. These basic requirements remain in the system. The current recession only confirms the need to pursue fiscal policies that encourage economic growth. The tax program is relatively new and must be given time to show its effectiveness.

Consequently, we urge the Senate Finance Committee to keep in place the savings and investment incentives which formed the basis for the ERTA.

The pulp, paper and paperboard industry is one of the most capital intensive in the United States. Its capital outlays this year will be close to $7 billion; we project it annual capital needs at $12.5 billion a year in the years 1985-1990. If the industry is to meet the potential needs of both the domestic and international markets in those years, it must make investment decisions now. API estimates that the accelerated capital recovery provisions that are part of the Economic Recovery Tax Act of 1981 will contribute an additional $1 billion a year to the industry's internal funding of capital requirements in 1985-1990.

The incentives provided in ERTA are only now beginning to work. To alter them would compound the effects of recession and cause more delays in capital projects.

The news that business is scaling back some capital spending plans may lead to the mistaken conclusion that the capital incentive program is not working.

The real factor behind the curtailment in capital expenditures is reduced profits which in part reflects high interest rates and the fact that, in the early stages of disinflation, prices move down faster than costs. Removing or postponing incentives now would only hurt.

NEED FOR STABILITY

Business and individuals cannot make long range savings and investment plans if the rules of the game are constantly changing. The long term investment decisions of U.S. business and individuals have been impaired since the early 1970's by the stop-and-go policies of the government. The present discussion of taxes is yet another example of the tendency of government to neglect the need for stability in creating the proper climate for long-term investment decisions. Consequently, we believe it would be harmful to make any major changes in the tax provisions that have already been enacted.

THE DEFICITS PROBLEM

Members of the American Paper Institute are mindful of the problems with the President's budget message which projects sizeable deficits continuing into 1987. This prospect is alarming to all of us. It does contribute to the unnecessarily high interest rates prevalent today. Here are some factors that need to be considered in evaluating this problem.

1. The higher deficits projected in 1983's budget compared with last year's estimate result almost entirely from recession induced factors:
   a) revenues in fiscal 1983 are projected $51 billion lower because of a lower forecast of dollar values of GNP and inflation;
   b) higher unemployment adds $8 billion to the expected outlays for 1983;
   c) higher interest payment and debt contribute another $31 billion to projected outlays for fiscal 1983.

   Consequently, the solution must be one that fosters and contributes to faster growth.

This clearly indicates that tax policies must be carefully evaluated at this time to ensure that growth is not hindered by tax changes or that the recession be lengthened.

2. Notable progress in spending cuts was made in 1981, but follow-up actions are needed in 1982. Congressional committees have not, to date, seriously come to grips with the need to reduce the rate of advance in government outlays. There are no indications, however crude, that a spending figure approximating the President's total is close at hand. We believe everyone, consumers as well as investors, would be encouraged if at least some progress toward a curtailed rate of government spending could be made now, whatever the mix. This could change the expectation component in interest rates. The pressing problems of entitlement programs may not lend themselves to adequate and fair solutions in the present crisis atmosphere. Long range and permanent solutions are needed for the chronic problems associated with these programs. Real and credible progress on these issues, however small, in the present session of Congress will convince investors that the nation is on the right track.

3. Savings have increased since the first small stage of tax cuts for individuals went into effect on October 1, 1981. A second stage of the tax cut particularly conducive to traditional savings outlets went into effect only on January 1, 1982, when the maximum rate on investment income dropped from 70% to 50% and the new provisions for Individual Retirement Accounts were introduced.

   These tax initiatives have in part been blunted by the recession; their positive impact should not be minimized by this temporary situation.

   The third stage, to take effect on July 1, 1982, should show an even more convincing response of savings to taxes. A significant change in the present tax policy now would be a premature judgment of the existing one.

   Yes, it is taking time, but the failures are not in the program but rather in those forecasters who overstated its impact.

CURRENT BUSINESS TAX INCREASE PROPOSALS

The Administration has proposed a number of tax increases, under headings such as "Selected Tax Revisions" and "Improved Tax Collection and Enforcement." Included in these proposals are the "revenue enhancing" measures outlined in September, plus some additional increases.

Our support of the President's tax program includes necessary selective tax revisions and changes designed to eliminate abuses and correct unintended loopholes.

The problem is that the provisions affecting industry, in the aggregate, would take back as much as 50% of the corporate tax reductions provided by Economic Recovery Tax Act of 1981 (the corporate tax reduction in the ERTA amounted to only about 20% of the total estimated cut).

Our specific comments on the Administration proposals point up some problems.

Minimium Tax

The minimum tax concept has the potential of seriously impairing the effectiveness of the investment incentives already in place and could have long range detrimental effects on capital formation. These incentives which are designed to speed up the rate of new capital formation are needed if industry is to increase its stock of capital goods more rapidly in the years ahead than in the previous decade.

Energy Credits

Our industry's record on energy conservation resulting from accelerated investment in energy conservation facilities has justified its use of energy tax credits under existing legislation which includes a sunset provision with appropriate transition rules. The Treasury Department, however, has proposed a restrictive transiton rule as part of its repeal of all business energy tax credits, effective January 1, 1983. We cannot support this new rule which would in effect impose retroactive penalties on taxpayers who have relied on existing law and transition rules.

Tax Exempt Bonds

We urge that tax exempt bonds continue to be available for pollution control financing and that facilities so financed continue to qualify for accelerated depreciation. Our industry has made excellent gains in reducing environmental pollution; use of tax exempt bonds for financing mandated, non-revenue raising pollution control facilities has been a key factor is this progress.

Safe-Harbor Leasing

The flexibility provided by safe habor leasing is an essential element of equity in the accelerated cost recovery system. The industry supports its use, particularly for capital intensive industries like ours, which have temporary earnings situations that prevent it from otherwise taking advantage of the investment incentives provided by the Economic Recovery Tax Act of 1981.

The public evaluation of safe-harbor leasing stresses the benefit to companies with earnings, while minimizing - and even ignoring - the capital spending benefits to those companies experiencing temporary reductions in cash flow. Forest product producers, who operate in both the housing and paper industries, are a good case in point. Their building product earnings have been hard hit by the slump in housing and yet they find a need to continue to spend in the paper segment of the business. The leasing arrangements have helped some of them miminize the adverse effect of reduced overall cash flow on the required investments in new paper capacity. Clearly, without flexibility, this interim adaptation would not be possible. We therefore urge that these benefits be fully evaluated in assessing the future rules relating to safe-habor leasing or some other form of flexibility.

Accelerated Tax Payment

One element of the proposal to accelerate corporate income tax payments is troublesome. This proposal would increase the required estimated tax payments from

80% to 90% of the current year's tax liability and would impose a severe penalty for underpayment. Compliance within a narrow 10% range would be extremely difficult. Estimates of annual operating earnings, tax depreciation and investment tax credits are educated guesses in the earlier portion of the year. Even post year-end decisions, such as those relating to pension expense deductions, could result in an inaccurate estimate of the tax liability during the tax year.

In summary, progress on federal spending restraint is the most significant need in business expectations; selective revenue enhancing proposals are also needed.

We see no immediate danger to the economy or to inflation from deficits in 1982 and in 1983. Beyond that, the balance will be determined by events that cannot be foreseen at present. Very difficult decisions must be made on the spending side. If they require more time for review and consensus that now exists, Congress ought to at least address the matter of achieving spending targets close to those established by the Administration as a first step. Additional cuts can be made later.

To raise taxes now would signal that Congress cannot discipline itself to do what the public seems to want and that is spending control and reduced taxes.

STATEMENT OF HAWKINS, DELAFIELD & WOOD

67 Wall Street, New York, New York 10005

MINIMUM TAX ON INCOME WHICH INCLUDES INTEREST ON STATE AND MUNICIPAL OBLIGATIONS

Preliminary Statement

This statement is submitted in accordance with Press Release No. 82-107 with regard to the hearings being held from March 16 through March 19 on the tax proposals in the Administration's budget. Specifically, this statement is directed to any consideration that the Committee may give to a minimum tax on income, including state and municipal bond interest. The principal points presented in the statement are summarized as follows:

A minimum tax on income including state and municipal bond interest, if enacted into law, would be unconstitutional. The decision by the Supreme Court of the United States in the Pollock case holds that a tax on the interest from state and municipal bonds is unconstitutional. The Sixteenth Amendment did not change the decision in the Pollock case. The history of the adoption of the Sixteenth Amendment confirms the Congressional and Supreme Court construction of its intent and meaning. To the extent that a minimum tax applies to interest on local housing authority obligations it also impairs the obligation of contract.

I. A MINIMUM TAX ON INCOME INCLUDING INTEREST ON STATE AND MUNICIPAL OBLIGATIONS WOULD BE UNCONSTITUTIONAL.

A minimum tax would include in the gross income of a taxpayer the amount of so-called "disallowed tax preferences" and would define the so-called "items of tax preference." Among such items might be any excess of interest on obligations which is currently excludable from gross income under section 103 of the Internal Revenue Code of 1954, as amended, namely the interest on "the obligations of a State, a Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia".

The Committee considered such a minimum tax under the Tax Reform Act of 1969 (H.R. 13270). The bill as proposed included a section which would have limited tax preferences to (1) one-half of the sum of the items of tax preference and the taxpayer's adjusted gross income or (2) $10,000, whichever is greater. Hawkins, Delafield & Wood submitted a statement to this Committee while that proposal was under consideration by the Committee. The statement as it related to the minimum tax proposals presented the same analysis that is contained herein. The proposal for a minimum tax on income which includes interest on state and municipal obligations was not included in the bill reported out of this Committee. Senate Report No. 91-552, Tax Reform Act of 1969, at 2029. Reconsideration of a minimum tax by the Committee should lead to the same result now as it did in

1969. If such a tax is proposed and includes income on state and municipal obligations, it would be unconstitutional.

Law, as Mr. Justice Holmes has told us, is a "prophecy of what courts do in fact." In our opinion, the Supreme Court would hold that such a tax on the interest on state and municipal obligations is unconstitutional for the reasons stated below. From the time the income tax was imposed in 1913 until now both Congress and the Supreme Court have adhered steadfastly to the constitutional doctrine that state and municipal bond interest is exempt from federal income tax. It would be strange for Congress to abdicate its obligation to respect constitutional limitations upon its power by levying a tax on such interest without new constitutional authorization.

The doctrine of federal immunity from state interference, including interference by taxation, is a general principle of constitutional law with which this Committee is undoubtedly familiar. The converse immunity of the states from federal interference is equally well established. In National League of Cities v. Usery, 426 U.S. 833, 842 (1976), the Supreme Court stated unequivocally that the constitutional doctrine of intergovernmental immunity imposes "limits upon the power of Congress to override state sovereignty, even when exercising its otherwise plenary powers to tax or to regulate commerce which are conferred by Art. I of the Constitution." The doctrine was specifically applied to interest on obligations of states and municipalites and of state and municipal instrumentalities by the

Supreme Court of the United States in the landmark case of Pollock v. Farmers' Loan & Trust Company, 157 U.S. 429 (1895) and on rehearing, 158 U.S. 601 (1895).

The case decided by the Supreme Court under the Sixteenth Amendment as well as the legislative history of the amendment in Congress during ratification by the state legislatures demonstrate that any claim that the amendment repudiated the rule of the Pollock case is unsupported by any judicial precedent, is unfounded in fact, and altogether spurious.

For the purpose of this statement it is not necessary or desirable to delve into the much repeated history of the constitutional doctrine of reciprocal immunity before August 15, 1894 when Congress enacted a statute which levied a tax upon net income, including the interest on state and municipal bonds.

At that time and until the Sixteenth Amendment became effective on February 25, 1913, Article I, Section 2, of the federal Constitution required the apportionment of "direct taxes" among the states according to population, as follows:

> "Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective numbers, which shall be determined by adding to the whole Number of free Persons, including those bound for Service for a Term of Years, and excluding Indians not taxed, three-fifths of all other Persons."

Article I, Section 8, of the Constitution also required that "Duties, Imposts and Excises" shall be uniform, as follows:

> "The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defense and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States;..."

A. The Pollock Case holds that a tax on the interest from state and municipal bonds is unconstitutional.

In the Pollock decision which considered the validity of the income tax law of 1894, the Supreme Court pointed out that the federal government had an unlimited power of taxation with a single exception and subject to two qualifications. The one exception was that "Congress cannot tax exports..." The two qualifications were that Congress "must impose direct taxes by the rule of apportionment, and indirect taxes by the rule of uniformity." 157 U.S. at 557.

In the first Pollock case the Supreme Court held that a tax on the rents and other income from real estate was a direct tax and consequently violated the Constitution because the tax was not "apportioned among the several States...according to their respective numbers." The Court also unanimously held that the taxing power, like any and all other powers of the federal government, was impliedly subject to the constitutional limitation that it could not be so exercised that the instrumentalities of the states were taxed. 157 U.S. at 584.

Thus, the first decision in the Pollock case held the income tax act of 1894 invalid in respect of (1) the tax on rents and other income from real estate and (2) the tax on the interest from state and municipal bonds. The justices divided equally on the constitutionality of the income tax pertaining to personal property other than state and municipal obligations and on whether the 1894 act as a whole was unconstitutional.

On rehearing the Supreme Court decided (four of the justices dissenting) first, that the tax on income from personal property was a direct tax and hence was invalid because not apportioned and, second, that the 1894 Act was unconstitutional in its entirety.

The Pollock decision was unanimous as to municipal bond interest because in the words of Mr. Justice Fuller, to tax the interest on municipal bonds "would operate on the power to borrow before it is exercised, and would have a sensible influence on the contract," and would be a "tax on the power of the States and their instrumentalities to borrow money and consequently repugnant to the Constitution." 157 U.S. at 586.

To the same effect was the separate opinion of Mr. Justice Field:

> "These bonds and securities are as important to the performance of the duties of the State as like bonds and securities of the United States are important to the performance of their duties, and are as exempt from the taxation of the United States as the former are exempt from the taxation of the States." 157 U.S. at 601

And Mr. Justice Brown who had concluded that "a tax upon rents or income of real estate is a tax upon the land itself" nevertheless said in the second Pollock decision:

> "The tax upon the income of municipal bonds falls obviously within the other category, of an indirect tax upon something which Congress has no right to tax at all, and hence is invalid. Here is a question, not of the method of

> taxation, but of the power to subject the property to taxation in any form." 158 U.S. 692-693

Thus, all the justices in both Pollock decisions, whether they subscribed to the theory that a tax on income was a tax on the source of the income or considered that theory untenable, came to the identical conclusion that the interest on state and municipal obligations could not be included in federally taxable income. It is clear, therefore, that the decision in Pollock concerning the unconstitutionality of taxing state and municipal bond interest rests not on the economic premise that a tax on income is a tax on the source of the income but on the inviolability of the borrowing power of the states and their political subdivisions.*

B. The Sixteenth Amendment did not change the decision in the Pollock Case.

This, then, was the law when the Sixteenth Amendment was declared in full force and effect by the Secretary of State on February 25, 1913. The Amendment reads:

> "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

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*The reluctance of the four justices in both Pollock cases to accept the theory that a tax on income is a tax on the source of the income was later shared by the Supreme Court in New York ex rel Cohn v. Graves, 300 U.S. 308 (1937) in which the New York State income tax on rents from real estate in New Jersey was upheld. Obviously, however, this was not the ratio decidendi of the Pollock case, because four of the justices who did not agree that a tax on income from personal property was a tax on the property itself joined with the other justices in invalidating the tax on municipal bond interest.

1. *The Congress has construed the Sixteenth Amendment consistently with the decision in the Pollock Case*.

Even before the Supreme Court decided that the phrase "from whatever source" in the Amendment relates not to the power to tax but to the requirement that certain federal taxes must be apportioned among the states according to their respective populations, Congress had also concluded that the object of the Amendment was to eliminate the necessity of *apportionment* irrespective of source in order that the income derived from the source of real and personal property could be taxed. Briefly stated, the Amendment means that a tax on income "from whatever source" is immune from the constitutional requirement of apportionment. 38 Stat. L. 168 (1913); 39 Stat. L. 758-59 (1916); 40 Stat. L. 329-30 (1917) and 1065-66 (1918).

When a revenue act was drafted during Word War I with a provision to include the interest on municipal bonds in gross income, the lack of power to tax such interest was expressed both in committee reports and congressional debate. It was recognized that lack of apportionment was not the objection to federal taxation of state and municipal bond interest but that the lack of power to tax such interest was absolute. The provision was omitted. H. Rep. No. 767, (65th Cong. 2nd Sess.) p.9; Sen. R. No. 617, (65th Cong. 3rd Sess.) p.6; 56 Cong. Rec. p.10933-41, 10628-38, 11181-86.

Such a contemporaneous construction of the Sixteenth Amendment by Congress from the time it became effective through

World War I is certainly an influential if not a controlling consideration in determining the meaning of the Amendment.

Later, in 1923, after the decision of the Supreme Court in Evans v. Gore, 253 U.S. 245 (1920), to be discussed below, Congress considered and the House of Representatives passed a constitutional amendment* to authorize the taxation of income derived from future issues of state and municipal bonds and to authorize states to tax the income of future issues of federal bonds. H.J. Res. 314, (67th Cong. 4th Sess.); H. Rep. No. 969, (67th Cong. 2d Sess.) The proposal failed to pass the Senate.

2. The Supreme Court has construed the Sixteenth Amendment consistently with the decision in the Pollock Case.

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*The proposed amendment read as follows:

"[H.J. Res. 314, Sixty-seventh Congress, fourth session.]

Joint Resolution Proposing an amendment to the Constitution of the United States. Resolved by the Senate and House of Representatives of the United States of America in Congress assembled (two-thirds of each House concurring therein), That the following article is proposed as an amendment to the Constitution of the United States, which shall be valid to all intents and purposes as part of the Constitution when ratified by the legislatures of three-fourths of the several States:

'ARTICLE .

Section 1. The United States shall have power to lay and collect taxes on income derived from securities issued, after the ratification of this article, by or under the authority of any State, but without discrimination against income derived from such securities and in favor of income derived from securities issued, after the ratification of this article, by or under the authority of the United States or any other State.

'Section 2. Each State shall have power to lay and collect taxes on income derived by its residents from securities issued, after the ratification of this article, by or under the authority of the United States, but without discrimination against income derived from such securities and in favor of income derived from securities issued after the ratification of this article, by or under the authority of such State."

(Continued)

In Evans v. Gore, 253 U.S. 245 (1920), the Supreme Court held (Justice Holmes and Brandeis dissenting) that the Sixteenth Amendment did not authorize an income tax on the salary of a federal judge in view of the fact that the Constitution provided that the compensation of judges "shall not be diminished during their continuance in office." Const. Art. III Sec. 1.

The Court then considered whether the constitutional inhibition against such diminution was modified by the Sixteenth Amendment. After an elaborate analysis of the Sixteenth Amendment the Court concluded that:

> "the genesis and words of the Amendment unite in showing that it does not extend the taxing power to new or excepted subjects, but merely removes all occasion otherwise existing for an apportionment among the States of taxes laid on income, whether derived from one source or another." 253 U.S. at 261-2.

Although Evans v. Gore was overruled in O'Malley v. Woodrough, 307 U.S. 277 (1939), it is clear from the opinion of Mr. Justice Frankfurter in the latter case that the decision that federal judges could be taxed on their salaries was based on the premise that, as Justices Holmes and Brandeis had said in their dissenting opinion in Evans v. Gore, a tax on salaries was not a diminution of compensation. Only that portion of the majority opinion in Evans v. Gore was repudiated and not one word in the opinion in O'Malley v. Woodrough questions the above-quoted conclusion of the Court in Evans v. Gore concerning the Sixteenth Amendment.

In Evans v. Gore the Supreme Court had referred to previous cases in which the Court had considered the Sixteenth Amendment, beginning with the opinion of Chief Justice White in Brushaber v. Union Pacific R.R. Co., 240 U.S. 1 (1916) which was the first case involving the scope and meaning of the Sixteenth Amendment. In that case, referring to the text of the Amendment the Chief Justice had declared (240 U.S. at 17-18):

> "...It is clear on the face of this text that it does not purport to confer power to levy income taxes in a generic sense-an authority already possessed and never questioned-or to limit and distinguish between one kind of income taxes and another, but that the whole purpose of the Amendment was to relieve all income taxes when imposed from apportionment from a consideration of the source whence the income was derived. Indeed, in the light of the history which we have given and of the decision in the Pollock Case and the ground upon which the ruling in that case was based, there is no escape from the conclusion that the Amendment was drawn for the purpose of doing away for the future with the principle upon which the Pollock Case was decided, that is, of determining whether a tax on income was direct not by a consideration of the burden placed on the taxed income upon which it directly operated, but by taking into view the burden which resulted on the property from which the income was derived, since in express terms the Amendment provides that income taxes, from whatever source the income may be derived, shall not be subject to the regulation of apportionment."

The Brushaber case was decided on January 24, 1916. On February 21, 1916, the Supreme Court handed down the decision in Stanton v. Baltic Mining Co., 240 U.S. 103 (1916). The decision was unanimous and again the Court reiterated the rule

> "...that the provisions of the Sixteenth Amendment conferred no new power of taxation ..." 240 U.S. at 112.

In Peck & Co. v. Lowe, 247 U.S. 165 (1918), the Supreme Court decided that the net income of a corporation derived from exporting goods was not a tax on exports prohibited by the Constitution. The unanimous opinion of the Court stated:

> "The sixteenth amendment, although referred to in argument, has no real bearing and may be put out of view. As pointed out in recent decisions, it does not extend the taxing power to new or excepted subjects, but merely removes all occasion, which otherwise might exist, for an apportionment among the States of taxes laid on income, whether it be derived from one source or another." 247 U.S. at 172-3.

Two years later, in Eisner v. Macomber, 252 U.S. 189, 206 (1920), the Court said:

> "As repeatedly held, this did not extend the taxing power to new subjects, but merely removed the necessity which might otherwise exist for an apportionment among the States of taxes laid on income."

In 1926 in Metcalf & Eddy v. Mitchell, 269 U.S. 514, 521, Mr. Justice Stone flatly declared:

> "...the sixteenth amendment did not extend the taxing power to any new class of subjects."

Five years later, in Willcuts v. Bunn, Chief Justice Hughes, 282 U.S. 216, 226 (1931), speaking for a unanimous Court which held capital gains on the sale of public securities to be taxable, reiterated the rationale of the rule as follows:

> "In the case of the obligations of a State or of its political subdivisions, the subject held to be exempt from Federal taxation is the principal and interest of the obligations. Pollock v. Farmers' Loan & Trust Company, supra. These obligations constitute the contract made by the State, or by its political agency pursuant to its authority, and a tax upon the amounts payable by the terms of the contract has therefore been regarded as bearing directly upon the exercise of the borrowing power of the Government."

Again in James v. Dravo Contracting Co., 302 U.S. 134, 153 (1937) Chief Justice Hughes restated the reason for income tax immunity of state and municipal bond interest as follows:

> "There is no ineluctable logic which makes the doctrine of immunity with respect to government bonds applicable to the earnings of an independent contractor rendering services to the Government. That doctrine recognizes the direct effect of a tax which 'would operate on the power to borrow before it is exercised' (Pollock v. Farmers Loan & Trust Co., supra) and which would directly affect the Government's obligations as a continuing security. Vital considerations are there involved respecting the permanent relations of the Government to investors in its securities and its ability to maintain its credit,-considerations which are not found in connection with contracts made from time to time for the services of independent contractors." (emphasis supplied)

And again, in Helvering v. Mountain Producers Corporation, 303 U.S. 376, 386 (1938) the Chief Justice repeated that:

> "a tax on the interest payable on state and municipal bonds has been held to be invalid as a tax bearing directly upon the exercises of the borrowing power of the Government (Weston v. Charleston***, Pollock v. Farmers' Loan & Trust Co.***)."

In the previous year Mr. Justice Cardozo had also pointed out in Hale v. Iowa State Board, 302 U.S. 95, 107 (1937):

> "By the teaching of the same (Pollock) case an income tax, if made to cover the interest on Government bonds, is a clog upon the borrowing power such as was condemned in McCulloch v. Maryland**** and Collector v. Day***."

And in Helvering v. Gerhardt, 304 U.S. 405 (1938), in upholding a federal income tax as applied to salaries of the employees of the Port Authority, Chief Justice Stone also referred to the hazard of impairing the borrowing power, stating that the immunity doctrine had been sustained

> "Where*** the function involved was one thought to be essential to the maintenance of a state government: as where the attempt was *** to tax income received by a private investor from state bonds, and thus threaten impairment of the borrowing power of the state, Pollock v. Farmers' Loan & Trust Company, 157 U.S. 429; cf. Weston v. Charleston, supra, 465-466."

The rationale of the Helvering v. Gerhardt case was followed in Graves v. New York ex rel O'Keefe, 306 U.S. 466 (1939) in which the Court held that the salary of an employee of the Home Owners Loan Corporation was not immune from state income tax. Both these cases relate to the same question whether intergovernmental immunities extend to the salaries of employees: Gerhardt to a federal income tax applicable to state employees and O'Keefe to a state income tax applicable to federal employees.

It is noteworthy that in the Gerhardt case Mr. Justice Stone pointed out that the Pollock case had no application because, as distinguished from the income taxation of public salaries, the income taxation of public securities would "threaten impairment of the borrowing power of the state." The O'Keefe case does not refer to the Pollock case, probably because of the Government's position that the income taxation of public securities was essentially different.

In his argument in Graves v. O'Keefe before the Supreme Court, Solicitor General Robert Jackson, later Justice of the Supreme Court, had explained that the Government accepted the distinction drawn by Chief Justice Stone in the Gerhardt case and had emphasized that where one deals with a debtor-creditor relationship, the borrower is the one who is burdened. The Solicitor General said that it was the presence of an actual burden upon the public instrumentality which issues public securities which distinguished the taxation of the interest on public securities from the taxation of the salaries of public employees.

More recently, the Supreme Court has invalidated federal regulation which unduly interferes with the performance of sovereign or governmental functions of the states. In *National League of Cities v. Usery*, 426 U.S. 883, 855 (1976), the Supreme Court held unconstitutional the application of the Fair Labor Act's minimum wage and maximum hour provisions to the states. The opinion states:

> "Congress may not exercise ... power so as to force directly upon the states its choices as to how essential decisions regarding the conduct of integral governmental functions are to be made."

Like the application of the Fair Labor Standards Act considered by the Supreme Court in *National League of Cities v. Usery*, the imposition of a tax on the obligations of the states (as well as their political subdivisions) would "operate to directly displace the States' freedom to structure integral operations in areas of traditional governmental functions" (426 U.S. 852) by increasing pressures on state budgets, a natural result of higher borrowing costs caused by the diminution in value of interest received by the holders of state obligations. The borrowing power of the states (as well as their political subdivisions) is certainly central to their ability to conduct their traditional operations and to provide the services traditionally furnished by them to the public.

The evidence is overwhelming that the views of Congress and the Supreme Court on the scope of the Sixteenth Amendment correctly express the purpose and meaning of the Amendment. That purpose was to permit Congress to levy and assess taxes on income without complying with the impracticable rule of apportionment according to population. Before the Amendment, Congress had the power to lay income taxes, but not without apportionment. After the Amendment, Congress need not apportion. The history of the Amendment proves that it was never intended to repeal the constitutional doctrine of reciprocal immunity from taxation of state and federal instrumentalities and obligations.

3. The history of the adoption of the Sixteenth Amendment confirms the Congressional and Supreme Court construction of its intent and meaning.

Sixty years ago President Taft sent a special message to Congress in which he urged a constitutional amendment which would confer upon the national government

> "the power to levy an income tax *** without apportionment among the states in proportion to population."

The President urged Congress not to reenact the 1894 income tax law which had been declared unconstitutional, saying:

> "For the Congress to assume that the court will reverse itself, and to enact legislation on such an assumption, will not strengthen popular confidence in the stability of judicial construction of the Constitution." 44 Cong. Rec. (June 16, 1909) p. 3344.

Previous to President Taft's special message, Senator Brown of Nebraska had offered a resolution for a constitutional amendment to the effect that "The Congress shall have power to lay and collect taxes on incomes and inheritances." Upon being informed in debate that Congress already had both of the powers in question and that only the rule of apportionment stood in the way of federal income taxation, Senator Brown offered, a few days later, a second resolution which read that "The Congress shall have power to lay and collect direct taxes on incomes without apportionment among the several states according to population." 44 Cong. Rec. pp. 1548, 1568-9, 3377. The Senate Finance Committee soon reported a resolution for a constitutional amendment in which the words "direct taxes" were changed to "taxes" and after "income" the words "from whatever source derived" were inserted. The proposed amendment then read:

> "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." 44 Cong. Rec. p. 3900.

The Committee gave no explanation of the reason for these changes.* However, the reason for the two changes is clear. The words "direct taxes" in Senator Brown's proposal would require explanation because it was not obvious why the amendment should only provide that direct taxes need not be apportioned. Hence, to eliminate the ambiguity of "direct taxes" the committee provided that taxes on income "from whatever source derived" need not be apportioned. Senator Brown's proposed amendment as clarified by the Senate Finance Committee did not grant power to Congress to lay and collect a tax on incomes; Congress already had plenary power to levy income taxes under Article I, Section 8 of the Constitution (quoted supra at p. 4). The phrase "from whatever source derived" was simply another way of saying that Congress need no longer apportion any tax on incomes, irrespective of the source of the income; that was the sole purpose of the Amendment proposed by President Taft and introduced by Senator Brown.

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*The only colloquy which took place when the revised resolution was reported to the Senate is found in 44 Cong. Rec. 3900.

The debate in Congress took one day in the Senate and one day in the House. The joint resolution proposing the amendment as redrafted by the Committee passed both houses and was immediately submitted to the states. No consideration was given at all to the question of the taxation of income from state and municipal bonds. The matter simply was not discussed. There was no indication that anyone sought to overturn the doctrine that state and municipal bond interest was immune from federal taxation which had been unanimously established in the Pollock case.

On January 5, 1910, Governor Hughes of New York submitted the amendment to the Legislature with a message calling attention to the words "from whatever source derived," suggesting that this might permit the taxation of income from state and municipal obligations, and questioning whether the amendment should be ratified.

On February 10, 1910, Senator Borah spoke in the Senate in answer to Governor Hughes' objection, stating in substance that no such meaning could be attached to the amendment. 45 Cong. Rec. 1694-9. He was followed by Senator Brown who concurred with Senator Borah's interpretation. Later, Senator Brown pointedly suggested that Governor Hughes stood alone in his fear.

> "It is a very significant fact that this amendment which was pending in Congress for days and was the subject of discussion by Congress and the press, should never have met this criticism while it was pending. In its present form it had the support of a unanimous Senate and a practically unanimous House of Representatives, who were all, judged by their votes, in favor of conferring this power on Congress, and yet no one in Congress ever suggested any change in the language of the resolution or proposed an amendment thereto to cover the objection now made.
>
> "Nor did any distinguished Governor from any of the 46 States, all of whom are now very loud in their protestations that the Government should have the power to tax incomes without apportionment, ever suggest that the amendment should have been modified in form in any respect. In this body the State of New York enjoys representation of the very highest character and most eminent ability, and yet New York on the roll call, as shown in the Congressional Record, was in favor of this amendment as it passed Congress, and was silent as to any suggestion that the language was faulty.
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> * * *
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> "The amendment does not alter or modify the relation today existing between the States and the Federal Government. That relation will remain the same under the amendment as it is today without the amendment. It is conceded by all that the Government cannot under the present Constitution tax state securities or state instrumentalities." 45 Cong. Rec. 2245-6 (Feb. 23, 1910).

On February 17, 1910, Senator Elihu Root of New York, a strong advocate for the amendment, wrote to New York State Senator Davenport giving his reasoned opinion that the amendment did not affect the immunity of state and municipal obligations. Senator Root wrote:

> "Much as I respect the opinion of the Governor of the State, I cannot agree with the view expressed in his special message on January 5, and as I advocated in the Senate the resolution to submit the proposed amendment, it seems appropriate that I should state my view of its effect.
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> * * *
>
> "The proposal followed the suggestion of the Supreme Court in the Pollock case.
>
> "The evil to be remedied was avowedly and manifestly the incapacity of the National Government resulting from the decision that income practically could not be taxed when derived either from real estate or from personal property, although it could be taxed when derived from business or occupation.
>
> "The terms of the amendment are apt to cure that evil and to take away from the different classes of income considered by the court a practical immunity from taxation based upon the source from which they were derived." 45 Cong. Rec. p. 2539-40 (Mar. 1, 1910).

Thus, three United States Senators sought to allay any doubt held by Governor Hughes. No other member of Congress or any Governor* expressed any other view. That Governor Hughes'

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*In a message to the New Jersey Legislature, dated February 7, 1910, John Franklin Fort, Governor of New Jersey, said:

> "***Nor am I inclined to accept the statement that the Supreme Court of the United States might construe the words 'from whatever source derived' as found in the pending amendment as justifying the taxing of the securities of any other taxing power."

(Continued)

doubts were set at rest is shown by his opinions after he became Chief Justice, in Willcuts v. Bunn (supra, p. 13), James v. Dravo Contracting Co. (supra, p. 13) and Helvering v. Mountain Producers Corporation (supra, p. 14).

No one would doubt that if the states and their municipalities were to attempt to impose state or local taxes upon interest received by their residents from obligations of the Federal government, such a levy would be unconstitutional in the absence of consent by Congress to such taxation. Weston v. City of Charleston, 2 Pet. (U.S.) 449 (1829). And this is so even though it is universally accepted that the state legislatures possess plenary power to tax, subject only to the limitations of their state constitutions.

It is our opinion that the unanimous holding in the Pollock case, reaffirmed so many times after the Sixteenth Amendment, that interest on state and municipal securities is free from Federal income taxation under the Constitution would be again reaffirmed by the Supreme Court and that therefore any bill considered by this committee which would impose a minimum tax applicable to such interest would be unconstitutional.

(Continued)
On February 23, Senator Brown, referring to the message of Governor Fort, of New Jersey, said:

> "It cheers our hearts to read in the press that President Taft agrees with the Governor of New Jersey, who, in a message to his legislature February 7 and since the New York message was transmitted, took immediate and direct issue with the governor of New York." (45 Cong. Rec. p. 2245)

C. To the extent that a minimum tax would apply to interest on local housing authority and agency obligations it would also be unconstitutional under the Fifth Amendment.

It is our opinion that if a minimum tax applied to the interest on bonds of local public housing authorities issued to finance low rent housing, slum clearance and urban renewal projects, the tax would violate the Fifth Amendment to the Constitution.

The United States Housing Act of 1937 provides as follows:

> "Obligations, including interest thereon, issued by public housing agencies in connection with low-income housing projects shall be exempt from all taxation now or hereafter imposed by the United States." 42 U.S.C.A. 1437i(b).

The Housing Act of 1949 provides in section 102(g) as follows:

> "Obligations, including interest thereon, issued by local public agencies for projects assisted pursuant to this subchapter, and income derived by such agencies from such projects, shall be exempt from all taxation now or hereafter imposed by the United States." 42 U.S.C.A. 1452(g).

Each of the above-quoted provisions of the United States Housing Act of 1937 and the Housing Act of 1949 that the obligations of local housing authorities and agencies "including interest thereon ***" shall be exempt from all taxation now or hereafter imposed by the United States constitutes a statutory contract between the federal government and the holders of such obligations. In our opinion, to deprive such holders to any extent of their immunity from federal taxation on the interest which they receive from such obligations impairs the obligation of the contract in violation of the Fifth Amendment which "protects rights against the United States arising out of a contract." Lynch v. United States, 292 U.S. 571 (1933). See also Farmers and Mechanics Savings Bank v Minnesota, 232 U.S. 516, 528 (1913).

Respectfully submittted,

Hawkins, Delafield & Wood
67 Wall Street
New York, New York 10005

Dated: March 17, 1982

BUILDERS AND ENGINEERS FOR INDUSTRY

NATIONAL CONSTRUCTORS ASSOCIATION
1101 15th Street, N.W. Washington, D.C. 20005 (202) 466-8880

STATEMENT FOR THE RECORD
THE UNITED STATES SENATE
COMMITTEE ON FINANCE

March 19, 1982

This statement on proposed changes in the completed contract method of accounting for tax purposes is presented for the record by the National Constructors Association. Our Association represents more than 50 of the nation's major engineering and construction firms.

Much of what you will be hearing and reading on the completed contract method of accounting for tax purposes today and in the months ahead will be complex and highly technical. It is a difficult area of tax practice. It has evolved out of experience going back more than sixty years.

The purpose of this statement is to help cut through all of the complexities and technicalities to show, in stark relief, what will happen if Congress and the regulators within the Treasury Department attempt to eliminate this time-tested, practical and demonstrably equitable method of tax computation.

DESIGNERS & ERECTORS
OIL REFINERIES—CHEMICAL PLANTS—STEEL MILLS—POWER PLANTS

The completed contract method is best understood in its historic context. It has been in use since 1918. It was developed for the construction industry. The reason for the method is that large construction projects typically take a number of years to complete. Profits or taxable income on such projects cannot reasonably be known until contract completion.

The method acknowledges the special requirements of construction contracting. It is, in fact, among the very few tax practices developed specifically with the needs of the construction industry in mind. It is not a tax break. The construction industry probably generates proportionately more tax revenues than most other industries. The completed contract method simply observes the principle that profits must be earned before they can be taxed. Working capital should not be taxed.

In the early 1970's certain classes of manufacturers with long-term or multi-year contracts, notably defense contractors such as the aerospace and shipbuilding industries, were brought under the completed contract method. That was done with the full cooperation of the Treasury Department and after the most rigorous analysis because earlier, less realistic tax practices had become a nightmare to administer and had bred long, costly and tortured litigation.

Like the construction industry, the aerospace and other high technology defense industries, must enter into contracts that reach out a number of years. The logic and equity of the completed contract method applies in such cases even though the industries involved operate in significantly different ways.

Treasury is currently proposing, essentially, to eliminate the completed contract method. It proposes to tax annually on the basis of progress payments or on the basis of percentage of contract completion. The theory is that that will produce substantial new revenues -- as much as $3 billion in the first year and $19 billion over the next several years.

The result will be devastating to the construction industry. And the theory under which the Treasury Department is operating is just plain wrong.

The construction industry, which qualifies for almost none of the tax benefits that apply to the manufacturing industry, will experience substantial losses in what is essentially working capital if the completed contract method is eliminated. Many construction companies, deprived of urgently needed positive cash flow, will be forced to borrow heavily in order to survive, assuming of course, that lending institutions would be prepared to take the risk -- which is highly improbable. Many construction companies simply will not be able to withstand the impacts and will go under. As it is, the construction industry is among the hardest hit by our nation's current economic problems, with industry-wide unemployment running at close to 20 percent, second only to unemployment in the auto industry. Construction volume has been in steep decline for several years.

The proposed change will not produce added tax revenues. On the contrary, it will most likely result in a substantial loss in net tax revenues. The facts are that the proposed change will:

- Force a number of construction companies to close down with a resulting loss to the national tax base and an increase in unemployment and in federal unemployment costs.

- Produce a flood of loss write-offs, that currently must be carried until contract completion, which will offset any theoretical tax revenue gain during the next several years.

- Produce new inflationary pressure on the economy by adding greatly to the risks and costs of doing business in the construction industry.

- Produce a substantial ripple effect through business losses among construction subcontractors and suppliers and defeat the purpose of the accelerated cost recovery system adopted last year.

- Add to the construction industry's costs of doing business in ways that will further reduce its ability to compete in foreign markets where it has already lost more than half of its market share in recent years.

- Produce considerable new complexities in the tax codes and generate new regulations that will be virtually impossible to administer.

The fact is that the construction industry, which accounts for one out of six jobs and as much as 20 percent of our nation's economic activity, already generates a disproportionate share of federal tax revenues. But there are limits.

And there is the simple matter of equity. The proposed change not only denies the construction industry access to the most realistic method of computing taxes due, but it also denies the industry most of the tax benefits accorded, quite legitimately, to the manufacturing industry.

Quite clearly, those who are proposing the change do not understand how the construction industry operates. The proposal to subject mobilization payments to taxation is just one example. In effect, mobilization payments are loans, not income. Nowhere in tax law is there a precedent for treating a loan as income for tax purposes.

Further, a knowledgeable look at the proposed changes in the tax treatment of certain costs for marketing, selling and advertising, bidding and interest, administrative and research, pensions and fringe benefits and general depreciation reveals an appalling lack of understanding of the way the construction industry works.

The proposed change is based on pure ignorance and on assumptions and theories not supported by facts. It represents a radical shift in basic tax policy that will have far-reaching adverse effects with costs that no one, based on current available data, can accurately predict.

It is sheer folly, as the history of recent years has too plainly shown, to reverse long-standing and time-tested tax practices in a hasty search for new revenues. We've lost substantial shares of foreign markets because of ill-considered tax policies that removed us from competition. We've lost a technological edge because of tax policies that discouraged investment in research. We're faced with an urgent need to renew our nation's aging and inefficient industrial plants because of tax laws that discouraged job-creating investment and risk-taking. All of those practices have had to be reversed. But not before they did great damage.

If the completed contract method of accounting is eliminated now -- or even substantially modified -- it will have to be restored in the very near future because the damage to one of our nation's basic industries will have proved intolerable and tragic.

And it will not have met the short term goal of generating revenues to help reduce the budget deficits.

STATEMENT OF FLETCHER L. BYROM, CHAIRMAN, COMMITTEE FOR ECONOMIC DEVELOPMENT, AND CHAIRMAN, KOPPERS CO., INC.

My name is Fletcher L. Byrom. I am Chairman of the Koppers Company and also of the Committee for Economic Development, an organization which is composed of 200 leading business executives and educators. I appreciate the opportunity to appear before you to discuss key economic policy issues that confront our nation today.

CED was founded just forty years ago, at a time when there were widespread fears that the end of World War II would bring a major economic downturn. The founders of CED were convinced that there was nothing inevitable about this. They believed -- correctly -- that with proper economic policies, both the U.S. and the world economy could experience steady economic growth and high employment, based fundamentally on the productive strengths of the private enterprise system. To achieve this result, however, they argued it was essential that short-run fiscal, monetary and other economic policies be systematically and steadily geared to the nation's broad long-range economic goals. This emphasis has been a central feature of CED's thinking ever since.

There are some definite parallels to that earlier situation today, though I would certainly not want to drive the analogy too far. Our economy currently has an exceptional opportunity to embark on a sustained period of economic growth, based primarily on increased private capital investment and restoration of the U.S. competitive position. In the last several years, a growing national consensus has finally emerged that inflation must be brought under firm control; that the progressive liquidation of the capital base of our nation's economic system had to be halted; and that greater reliance needs to be placed on competitive market forces. Yet progress in these directions is now being seriously impeded by the high level of interest rates that is significantly related to the enormous prospective budget deficits and by the continuation of economic slack in this high-interest rate environment. These conditions are swamping the potential favorable effects on investment of recent policy changes, including particularly the major improvements in capital recovery allowances instituted last year.

There is now growing appreciation that without major further action, the budget deficit will not only rise well above the hundred billion dollar mark in 1983 but will show successive yearly increases thereafter. This must simply not be allowed to happen -- and both the markets and the public need to receive clear indications soon that it will not happen. It is imperative that early and convincing action be taken to reduce the magnitude and change the direction of these deficits to levels that are consistent with lower interest rates and sound economic recovery. A downward trend in these deficits must be clearly demonstrated and confidence built that such a trend will be sustained.

What I particularly want to stress here, however, is the importance of approaching the task of reducing the deficit in a way that is consistent with key long-term goals for the economy. Let me comment briefly on four of these goals that we regard as centrally important.

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First, there is need for a progressive, year-by-year reduction in the inflation rate until essential price stability is achieved. The recent sharp deceleration in the rise of the Consumer Price Index is of course very gratifying. It would be a mistake, however, if we were to declare victory over inflation prematurely. As the chart attached to my testimony shows, the overall inflation rate has dropped significantly in all recent recessions, only to show a more pronounced rise in each recovery phase. There are strong reasons for believing that we are now witnessing more permanent progress toward bringing down the underlying inflation rate. The trend in various recent labor agreements toward more emphasis on labor-management cooperation to achieve greater productivity is particularly encouraging in that connection. But adequate progress toward the goal of reducing inflation cannot be taken for granted and fiscal and monetary policies, in particular, must be conducted on the assumption that inflationary risks remain great.

A second central policy aim is the achievement of healthy economic growth and high employment. Given the continuing inflationary threat, some moderation in the rate of long-term economic growth from what otherwise might have been desirable is probably necessary. But demand restraint must not become so severe that it blocks out necessary incentives for capital formation and productivity growth.[1]

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[1] See CED's 1980 policy statement, Fighting Inflation and Rebuilding a Sound Economy, p.11

Third, public policies need to be redirected so that a significantly greater share of the growing real Gross National Product will be devoted to investment and saving. We need more investment not only in new plant and equipment but also in more rapid technological progress and innovation, in domestic energy production and conservation, in improved skill training and education, and in public infrastructure.

Fourth, for reasons of both equity and humanity, national policy can and should give adequate weight to the concerns of those disadvantaged members of our society who have the greatest need.

Let me now outline the kind of approach toward reducing the deficit that, I believe, would adequately balance the various goals I have cited. While the specifics of this appraoch are my own, they are largely in line with positions that CED has supported in the past. On the basis of an informal check with other CED trustees, I also believe that they would have wide support within our organization.

1. The total reduction in the projected deficit must be adequate to make a major dent in existing inflationary expectations and reduce pressures on interest rates and financial markets sufficiently to allow for a major revival of capital investment.

2. Given the magnitude of the required cuts, no major segment of the budget should be excluded from consideration. Defense spending should be subjected to the same intensive scrutiny that has been applied to non-defense programs. This should permit significant savings from projected increases, at least by fiscal years 1984 and 1985, without any

weakening in our basic defense posture. Better-honed strategies, plus improved procurement and pre-purchase planning ought to enable us to get more for our money. Such careful scrutiny of defense spending can strengthen our defense posture, because a strong economy is in itself a key ingredient of U.S. overall national security.

3. In the non-defense area, an important part of budgetary savings should come from slowdowns in the indexed growth of entitlement programs, including Social Security, which have been adjusted annually on the basis of the Consumer Price Index or some roughly equivalent index to take account of inflation. It would be neither realistic nor equitable to concentrate the principal burden of budget cuts on a narrower range of social programs, particularly those that were already subjected to heavy cuts last year. Indexed entitlement programs now constitute more than one-third of the total federal budget and an even larger portion of the non-defense budget. Adjustments to take account of inflation for these programs have considerably exceeded the increase in average wages in the past few years.

On grounds of equity, therefore, there is a strong case for linking future increases in Social Security and other entitlement benefits to average wage increases rather than the rise in consumer prices whenever average wage increases are less than the consumer price rise. CED's Research and Policy Committee specifically endorsed such an approach with respect to Social Security in its statement on retirement policy.1/ However,

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1/ See CED policy statement, Reforming Retirement Policies, September 1981, p.9

while this rule would have produced important budgetary savings in the past few years, it cannot be counted on to produce savings in the next few years. Most current forecasts suggest that the rise in average wages will exceed increases in the Consumer Price Index, in line with more normal past patterns.

Hence, a number of other possibilities should be considered if budgetary savings are to be achieved through a slowdown in the indexed growth of entitlement programs. As we indicated in our statement on retirement policy last year, indexing of Social Security benefits at less than 100 percent for a period of several years would be equitable simply to correct in part for past increases in Social Security benefits in excess of average increases in wage rates.

One way to accomplish this purpose would be a one-year or fifteen month moratorium on cost-of-living adjustments for all entitlement programs, starting this July and extending until either July 1983 or the end of the fiscal year in September 1983. According to the Congressional Budget Office, this would yield annual budget savings of $18 billion by FY 1983 and $22 billion by FY 1985. About three-quarters of these savings would come from Social Security. Another option would be to combine such a one-year or fifteen-month moratorium for all entitlement programs with allowing cost-of-living adjustments in subsequent years only for CPI increases in excess of 3 percent. By 1985, this combination (assuming a one-year moratorium) would produce an annual saving of $38 billion. A third option might be to start this July with the practice of basing cost-of-living adjustments on the rise in the CPI less three percentage points, yielding estimated savings of about $7 billion in FY 1983 and $24 billion in FY 1985.[1/] In connection with all of these options, some exceptions to the rule for less-than-full indexing may be desirable to aid persons in the lowest income categories.

4. Budgetary savings in other programs are undoubtedly possible, in part through greater management efficiency. Care must be taken, however that essential social safety nets are in fact preserved. Moreover, in various programs such as those concerned with longer-term investment in productive plant and equipment and also in human resources, some budgetary cutbacks would actually be counterproductive in terms of the longer-range objectives I have outlined. I consider it particularly important, for example, that adequate funds be allocated for training the hard-to-employ, provided these programs are properly designed. Similarly, while I see a need for tightening up on student loan programs at both the college and graduate levels, I believe that overly drastic cuts in this area would run counter to the national need for more adequate investment in the kind of education and training that our workforce will need to be able to meet the requirements of the coming decades.

5. Even with a generous estimate of the savings that can be achieved through the measures I have recommended on the expenditure side

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1/ Still another option: holding cost-of-living adjustments to 85 percent of the rise in the CPI. Estimated savings: about $3 billion a year in FY 1983 and $9 billion in 1985.

of the budget, it is clear that a substantial contribution will also have to come from the revenue side if the overall deficit is to be brought down to manageable proportions.

6. A number of reasonable increases on the revenue side of the budget should be possible that would not interfere with achieving the long-run goals I have cited. In general, tax increases that fall on consumption, whether it be personal or business, are to be preferred. Some of these increases can be brought about by greater reliance on user taxes, as proposed by the Administration. Also, serious consideration should be given to increasing various federal excise taxes on alcohol, cigarettes, gasoline, and some luxury items, starting in 1983. Nor do I think corporations should go untouched. Review of certain of the tax changes affecting corporations that were enacted last year may be appropriate, specifically including the so-called safe harbor leasing provision and some of the tax allowances on hydrocarbon extraction. At the same time, it is vitally important that needed incentives for investment in new plant and equipment be preserved, including especially provisions for adequate capital recovery allowances. The patent inadequacy of these allowances prior to last year, coupled with inflation and excessive regulatory burdens, was a major factor in the effective decapitalization of a great deal of our capital-intensive industry, particularly steel, non-ferrous metals, railroads, the airlines, and utilities.

I am concerned about the potential adverse effects of the proposed minimum corporate tax on investment incentives. For example, according to a recent article by Emil Sunley, Director of Tax Analysis for Deloitte, Haskins and Sells, about half of the revenue gain through imposition of the minimum tax would derive from limitations on just one tax preference, namely the use of the investment tax credit.[1] As Sunley goes on to explain,

> Any minimum tax blunts the incentive effects of tax preferences. Congress, by enacting a minimum tax, in effect is saying that if a business engages only a little in activities encouraged by tax subsidies, ...no minimum tax is imposed. But if the business is good at these activities and specializes in them, it will have to pay the minimum tax, putting it at a competitive disadvantage.

7. Even if the probable yield that can be realized from the kind of revenue measures I have cited should prove to be substantial, I find it hard to envisage that it would, in conjunction with realistically achievable expenditure cuts, be substantial enough to produce the decisive reduction in the potential deficit that is needed. Hence, I believe that we must look for additional revenues through deferral of the provision for indexing personal income taxes beginning in FY 1985 and, possibly, elimination or postponement of at least part of the personal income tax cut now scheduled for 1983. The potential added revenues from either or both of these steps, or possible variants that have been proposed, could, of course, be very large.[2]

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[1] See Tax Notes, February 15, 1982.

[2] Shown below are estimated revenue effects of various alternative possibilities for deferral of the indexation of personal income taxes and of the scheduled reductions in these taxes. (Sources: Congressional Budget Office, Reducing the Federal Deficit: Strategies and Options (February 1982) and, for Item (e), Office of Senator Dole.)

Footnote 2, continued

I would consider postponement of tax indexing ahead of any decision to defer the 1983 personal tax reduction. To reach the overall goal for reducing the deficit, however, it may as a last resort also be necessary to defer or stretch out at least part of the scheduled 1983 tax cut.

Footnote 2/ from p.9 continued:

(a) Full deferral or elimination of the scheduled 10 percent personal income tax cut in 1983 and of the tax indexing now scheduled to start in 1985. According to the Congressional Budget Office, these two steps combined would, on an annual basis, cut the prospective deficit by $9 billion in 1983, $37 billion in 1984, $54 billion in 1985, and $76 billion in 1986. On a cumulative basis, the estimated revenue savings would come to $46 billion in 1984, $100 billion by 1985, and $176 billion by 1986.

(b) Deferring tax indexation but retaining the 1983 tax cut. This would yield estimated annual savings of $12 billion in 1985, $30 billion in 1986 and $51 billion in 1987.

(c) Eliminating or deferring the entire 1983 personal income tax cut but retaining tax indexing. Annual savings: $9 billion in 1983, $37 billion in 1984, $40 billion in 1985 and $44 billion in 1986. Cumulative savings by 1985: $86 billion.

(d) Reducing the 1983 tax cut to 5 percent. This would, by itself, produce annual budget savings of $4 billion in 1983, $18 billion in 1984, $20 billion in 1985 and $22 billion in 1986. Cumulative savings by 1985: $42 billion.

(e) "Stretching out" the scheduled 1983 tax cut, so that a 5 percent cut would be scheduled for July 1, 1983 and another 5 percent cut for July 1984. This would save $4 billion in 1983 and $14 billion in 1984, but only $1 billion a year in 1985-87. Cumulative savings by 1985: $19 billion.

(f) Eliminating the scheduled 1983 tax cut but starting tax indexation in that year instead, as proposed by Senator Dole. Assuming 7 percent inflation in 1983, this would by 1985 produce about three-fourths of the accumulated savings generated by reducing the 1983 tax cut to 5 percent.

(g) Making activation of tax indexation beginning in 1985 contingent on specified improvements in the budget situation.

CED strongly favors a longer-run objective of gradually reducing the total share of GNP taken by taxes, in balance with the phased reduction in government spending as a share of GNP. We have also taken the position, however, that the nation must be prepared to finance any necessary increases in defense spending on a noninflationary basis. In this sense, deferment or stretch out of all or part of the 1983 tax cut and of the subsequent income tax indexation ought to be seen as part of the price that has to be paid for the projected sharp step-up in national security outlays.

If agreement on any package of budgetary trimming is to have its desired effect on the financial markets, business and the public, several conditions must be met. The first of these, to be quite blunt, is that the proposed plan must be fully credible. On too many occasions spanning several Administrations and Congresses, budget numbers promulgated by the Executive Branch as well as the Congress have failed to meet that condition. Yet given the amount of supplemental information now available and the number of analysts with sharp pencils in financial houses, business firms, universities and the press who follow these numbers, it now usually takes only a relatively short time before any lack of credibility becomes apparent to everybody. I very much hope, therefore, that any agreed new program for deficit reduction will from the start be one that is generally accepted as "adding up."

There must also be convincing indications that the proposed reductions will, in fact, be carried out. Congress' recent failure to pass a meaningful budget resolution and current talk of a possible breakdown of the entire budget process are clearly very detrimental in this connection.

I am not one of those who put the blame for all this on the budget process as such. The present procedures represent a major advance over the way things were done prior to the Budget Act of 1974. Without the tools provided by that Act, the various participants in the current budget debate would not be able to discuss detailed budget projections for three or more years ahead, argue about economic assumptions, or come up with prompt estimates of potential budget savings through alternative approaches. Cynics might say this may not be all bad. But the fact is that the new process has given Congress major new tools for making more rational budget decisions. The chief problem lies in facing up to the basic choices now that they are being presented with greater clarity.

I do not think that new legislation is required this year to improve the budget process. But if the business community is to have continuing confidence that agreement on a deficit-reducing package will actually be carried out, it will be highly important that the Congress passes the required legislation expeditiously and adheres to the basic requirements and timetable of the budget procedure. We believe that various other steps should also be taken to make that procedure more effective, such as giving binding force to the first resolution, bringing credit activities under closer control, moving various activities now classified as "off-budget" back into the budget, and subjecting not only the spending side but also the revenue side of the budget to closer scrutiny, particularly where it involves tax provisions that have the same purpose as particular expenditure programs and should be examined jointly with such programs. The most important immediate need, however, is to reach an agreement on an adequate cutback in the budget deficit that will be widely regarded as realistic.

With a credible program for progressively lowering the deficit in coming years, there is a strong chance that interest rates will be significantly reduced. Such a fiscal policy would provide assurance that monetary policy could be directed at fostering rates of monetary and credit expansion adequate to support noninflationary real growth in the economy.

Cutting deficits and improving the fiscal-monetary mix of course constitutes only part of what is needed to restore healthy noninflationary growth and make our economy more productive as well as competitive. Another part of the answer lies in removing inappropriate disincentives to the effective working of the market mechanism and in positive measures to increase productivity. The sharp slowdown in U.S. productivity growth since 1973 has been profoundly disturbing, particularly when one considers that our rate of productivity growth has lagged significantly behind those recorded by many of our major competitors among the industrial countries. CED is currently working on an in-depth study of how productivity might be improved, as well as on a parallel study that examines a desirable industrial strategy to make this country more competitive and allow it to adapt effectively to the emerging needs of the 1980s.

At the same time, we believe there is need for greatly increased focus on the potentials for more extensive public-private cooperation in a variety of areas. Just a few weeks ago, CED issued a new policy statement on the opportunities which public-private partnership poses for urban communities.[1/] That statement examines in detail what has made for successful public-private cooperation in seven major cities -- Atlanta, Baltimore, Chicago, Dallas, Minneapolis-St. Paul, Pittsburgh, and Portland, Oregon -- and points to the elements of these successes that may be transferable to other communities.

Our earlier 1978 statement Jobs for the Hard-to-Employ: New Directions for a Public-Private Partnership similarly pointed to successful instances of public-private cooperation in developing training and job programs for the disadvantaged. While that statement served as a catalyst for increased private sector involvement in these efforts, including the creation of Private Industry Councils, we are by no means satisfied that these efforts are as vigorous or effective as they could be. CED's Program Committee expects shortly to issue a statement which spells out the steps that we believe are needed to achieve more effective and sustained business involvement in this area. Steps to enable smaller businesses to participate effectively in these programs will be an important element of our recommendations since a high proportion of the new entry-level jobs for the disadvantaged opens up in smaller businesses.

[1/] See CED policy statement Public-Private Partnerships: An Opportunity for Urban Communities, February 1982.

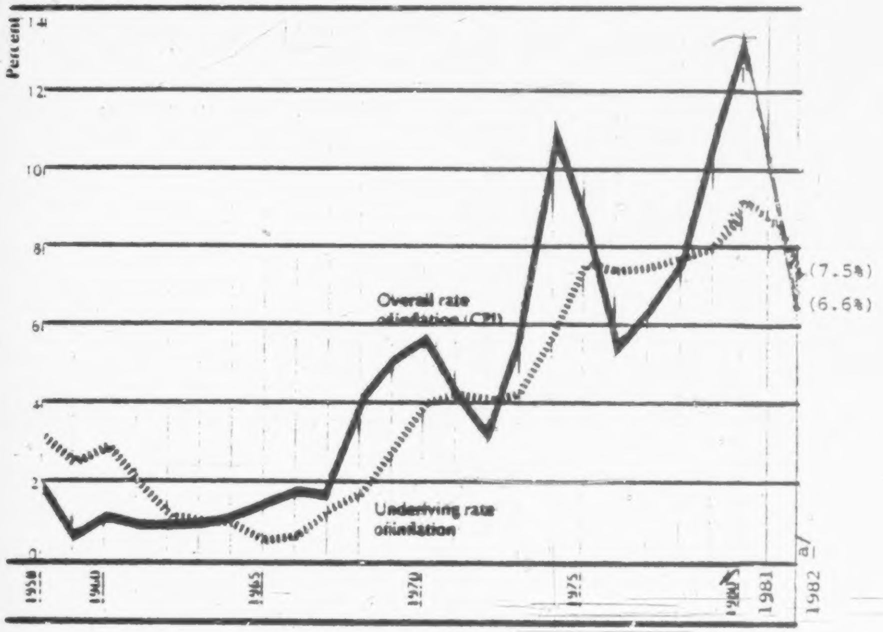
I myself have taken a special interest in another area of needed public-private partnership: namely, ways in which businessmen can help to improve the caliber of our nation's high school graduates. The quality of workers entering the labor force in the next few years will be of major importance for the success of our efforts to revitalize the nation's economy. There is a great deal that business can do, in cooperation with local educational institutions, to assist in developing high school graduates who are not only well-rounded academically but who also have the flexibility and capacity for leadership needed to cope with the challenges of the coming decades.

I want to make it very clear that in emphasizing the potentials for public-private partnership in a variety of fields, we are not suggesting that the private sector can or should be expected to assume full responsibility for meeting needs that will result from current cutbacks in federal domestic programs. What we are saying is that with time and proper preparation, public-private cooperation at the local level can accomplish a great deal more than is generally realized. This can, in time, also help lighten the burden on public sector budgets. We are also saying that success in these efforts does not depend on money alone but requires creative and energetic personal involvement by public and private local leaders to work out mutual problems in a constructive fashion. The President's new Task Force on Private Sector Initiatives which is headed by my good friend, Bill Verity, is working hard on plans for encouraging such involvement.

All of these efforts at public-private cooperation can contribute to a national economic environment that is conducive to steady, non-inflationary growth. But early and convincing action to restore the more viable fiscal-monetary mix needed to achieve that goal should be everyone's first order of priority today.

FIGURE 1

Overall and Underlying Rates of Inflation



Various alternative measures can be used to depict overall and underlying inflation. In this chart, the overall inflation rate is represented by the consumer price index (CPI). Underlying inflation is represented by the "core rate" concept developed by Data Resources, which measures the weighted average of the trend rates of growth in unit labor and capital costs (with weights equal to the estimated shares of these costs in total value added and with adjustments for productivity growth). For a detailed technical description, see Otto Eckstein and Robin Siegel, "More on Core Inflation," *Data Resources U.S. Review* (June 1979), pp.I.19–I.23.

a/ 1982 figures partly estimated by Data Resources.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics, and Data Resources, Inc.

STATEMENT OF THE

AMERICAN PETROLEUM INSTITUTE

SUBMITTED TO THE

SENATE FINANCE COMMITTEE

Regarding

ADMINISTRATION PROPOSAL FOR A
CORPORATION MINIMUM TAX

Washington, D. C.
March 19, 1982

SUMMARY

I. PETROLEUM INDUSTRY PROFITABILITY, CAPITAL EXPENDITURES, AND TAXES

A. Current Petroleum Situation. Oil demand and prices are falling. The industry's tax burden is up sharply. Profitability is down. Capital investment plans are necessarily being reevaluated and sometimes cut back -- after being increased sharply in response to higher prices and profitability. Yet, the industry's success in reversing the decline in U.S. production and diversifying foreign sources of supply is jeopardized by proposals for increased taxes, even though it would be premature to conclude that the oil crisis is over.

B. Movement of Oil Industry Profits. There is a widely held misconception that oil industry profits move only up. Those who argue that profits are ever-higher ignore profitability (the relationship of profits to investment) and inflation. Moreover, profits have sometimes risen and sometimes fallen. Recently, they have been falling.

C. Profitability. Rate of return on investment is a far more significant indicator of performance than the absolute level of profits. Despite the high risks of petroleum exploration, oil company returns on shareholder equity have been well above non-oil manufacturing returns in only four years since 1968 (1974, 1979, 1980 and 1981). In 1981, oil rates of return began falling once more.

D. Capital Expenditures. Increased profitability provided both an incentive and a source of cash for increased capital outlays. Oil companies responded with a massive increase in investment -- from about $10 billion per year in the early 1960's to about $60 billion per year (annual rate) early in 1981. Decreasing profits have, however, led to reductions in planned expenditures. Only about six percent of oil company capital expenditures have been for facilities outside the energy and petrochemical fields. Petroleum companies invest 67 percent of their funds, in contrast to 56 percent for non-oil manufacturing.

E. Tax Burden. The petroleum income tax burden for 1981 was comparable to that of other companies -- about 38 percent. However, windfall profit taxes raised that figure to 57 percent -- exclusive of state severance taxes and deferred income taxes, which are high in industries (such as petroleum) that invest heavily.

II. THE ADMINISTRATION'S PROPOSED CORPORATE MINIMUM TAX

A. In General

1. Additional taxes on the petroleum industry which would result from the Administration's proposed Corporate Minimum Tax (CMT) would force further reductions in exploration and development by U.S. companies both at home and abroad, thereby jeopardizing the progress that has been made in recent years to reduce the world's dependence on OPEC oil.

2. The proposed CMT fails to allow full cost recovery for capital expenditures which may be deducted at an accelerated rate for regular tax purposes. As a result, many taxpayers will incur a substantial CMT liability even though

their effective federal income tax rate under existing law is well above the CMT rate. Thus, the CMT would tax recovery of capital as well as economic income. In effect, the CMT would become a tax on corporate investment.

3. The CMT could effectively deny any benefit from the investment tax credit (ITC) and destroy most of the benefit from the Accelerated Cost Recovery System (ACRS) adopted by Congress last year to stimulate new investment, thus slowing or even precluding recovery in many depressed industries. New companies with low profits due to start up costs, investment tax credit and accelerated deductions for capital improvement would be particularly hard hit and may not survive.

B. Intangible Drilling and Development Costs

1. Since current expensing of IDC yields results similar to 5 year ACRS plus ITC which are not treated as preferences for CMT, there is no justification for treating IDC as a preference item. Under the Administration's proposal, oil and gas producers are not offered a choice of using the preference or electing five year ACRS with ITC for each property and avoiding the preference detriment, as other taxpayers are permitted to do in the case of existing timing preferences. Moreover, corporate producers would be denied the offset for oil and gas net income available to individuals.

2. The proposed treatment of intangible drilling and development costs as a preference item to be added to the CMT base fails to recognize that current expensing of capital cost was generally accepted in 1981 as the standard against which any capital cost recovery system should be measured. While Congress ultimately chose five year ACRS as the recovery mechanism for most machinery and equipment, it was with the knowledge that when combined with the 10 percent ITC, five year ACRS yielded about the same present value tax effect as current expensing.

C. Percentage Depletion. The last vestiges of percentage depletion now available to corporate independent producers would be further reduced by the CMT. Using historical cost as the criterion for the preference fails to recognize the erosion of capital values that has taken place through inflation and fails to recognize the increasing real cost of replacing existing reserves.

D. Foreign Operations Under the Proposed Minimum Tax. The limited credit against CMT for foreign taxes paid fails to protect U. S.-based companies adequately from additional U. S. tax on foreign-source income in all instances. To the extent U. S. companies are forced to pay higher taxes on foreign income than their foreign based competitors, the U. S. will continue to lose its position of prominence in the world's economy.

CONCLUSION

Overall, the CMT, like its predecessors, is a poorly conceived attempt to raise additional revenues under the guise of fairness. In effect, it is a tax on corporate investment, and in many instances will tax the "beneficiary" of the so-called tax "preferences" with effective rates greater than if no preference existed.

I. PETROLEUM INDUSTRY PROFITABILITY CAPITAL EXPENDITURES, AND TAXES

A. Current Petroleum Situation

The world oil industry is in a slump. Oil demand and oil prices are falling. Current oil consumption ~~in both the U.~~ S. and the other industrialized OECD countries is about 15 percent below its peak level in 1978.

The result is that oil is being sold unofficially at $4 to $6 a barrel below OPEC prices, and more and more analysts are questioning OPEC's ability to maintain its basic price of $34 a barrel. In constant dollars, current Rotterdam spot prices are about 40 percent below the heights reached during the 1979-80 oil crisis.

The profit outlook for oil companies is similarly negative. Stock prices for U. S. oil companies have led and exceeded the present market downturn. On average, major oil company equities have fallen about 50 percent from their 1980 highs, significantly more than the 20 percent decline in the general market. Investors are concerned that expenditures made by oil companies in anticipation of continually high and rising oil prices could be unprofitable with further erosion of demand and price cutting.

The oil companies are also reassessing their operations. While outlays on oil exploration and development proceeded at record high levels during 1981--double the 1978 spending level in current dollars--current and future investment plans are now being reevaluated and sometimes cut back, especially when they involve high-cost energy from unconventional sources or frontier regions. After peak activity in 1981, there is already a decline in drilling rigs now working in the United States, as well as a slide in seismic exploration, the first stage in the search for oil. And to accommodate lower current and prospective oil demand, companies are closing refineries, reducing inventories, trimming the number of marketing outlets, and continually looking for new ways to cut costs for consumers.

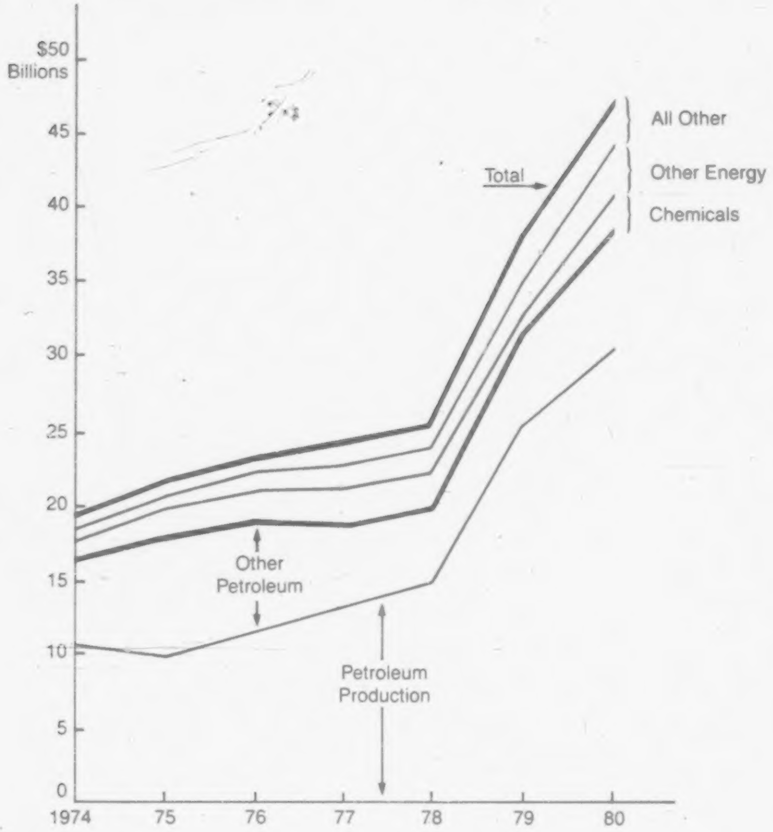
In the face of receding demand and falling profits, the taxes paid by oil companies continued to rise. U. S. income and windfall profit tax liabilities incurred by a representative group of 19 oil companies grew to $26 billion in 1981 from $16 billion in 1980. Because U. S. income before these taxes rose at a slower rate, the oil companies' effective tax rate (current income taxes plus the U. S. windfall profits tax divided by income before such taxes) increased from 32 percent in 1979 to 43 percent in 1980 and 57 percent in 1981. In contrast, the average effective income tax rate for all U. S. corporations (current taxes divided by pretax income) remained at about 37 percent throughout the 1979-81 period. And these relative tax rates do not reflect the practice of state and local governments to tax U. S. oil producers more than other kinds of companies. In particular, they exclude the billions of dollars of extra severance taxes and property taxes paid by U. S. oil producers.

Total windfall profit tax collections in the United States increased from $10 billion in 1980 to about $28 billion in 1981 (before allowance for income tax offset). In combination with other federal and state taxes on oil output and income, the effect of the windfall profit tax has been to strip away about 80 cents of each additional dollar of oil company revenue due to U. S. oil price decontrol.

Even though the oil industry's tax burden is already the highest in the country, Congress is considering additional levies on oil producers. New taxes would further squeeze an industry already caught between declining demand and prices, on the one hand, and rising taxes and investment spending on the other. In order to finance new taxes, oil companies would be forced further to reduce their efforts to find and develop new energy supplies. Such a reduction would jeopardize the progress that has been made in recent years to reduce the world's dependence on OPEC oil. Between 1974 and 1981, the net additions to property, plant and equipment of the leading U. S. oil companies more than doubled. And, as Chart 1 illustrates, the additions were primarily for petroleum activities,

Chart I

Worldwide Additions to Property, Plant and Equipment of 26 U.S. Oil Companies



Source: Survey by Office of Financial Reporting System, U. S. Department of Energy.

especially the development of new supply in non-OPEC countries around the world. Production of crude oil has even been increased somewhat in the United States after a decade-long downward trend. U. S. oil imports are now below 5 million barrels per day, compared with a peak level of almost 9 million barrels per day in 1977. It is clear that oil companies have responded positively and successfully to the increases in oil prices and profits during the 1970's.

While oil demand has dropped sharply in recent years, and may continue to drop in the years ahead, it is premature to conclude that the oil crisis is over. As former Secretary of Energy James Schlesinger said, "I suspect the energy crisis is over until we have our next energy crisis." The success that oil companies have had in reversing the decline in U. S. oil production and diversifying oil supplies worldwide ought not to be rewarded with the imposition of new taxes.

B. Movement of Oil Industry Profits

A widely held misconception about oil industry profits is that they move in only one direction from year to year -- up. Over the long term, of course, increased profits will be earned by most industries in a growing economy -- especially with inflation. (Total manufacturing profits almost quadrupled from 1960 to 1980.) However, profits rarely grow steadily year-after-year without interruption.

Those who seek to demonstrate continuous increases in oil profits usually select the stable years prior to the 1973-1974 market disruptions associated with the Arab oil embargo as a base year and compare this with the years immediately following the 1979 disruption associated with the Iranian revolution. Such a comparison conceals the true pattern of oil profit movements over this period.

In the first place, the comparison says nothing about profitability, that is, about the relationship of profits to the amount of capital invested (see Section C below.) Moreover, the comparison ignores the corrosive effects of inflation on the buying power of the profit dollar. Finally, the beginning-to-end comparison conceals two important cycles in oil profits reflecting the 1973 and 1979 market disruptions.

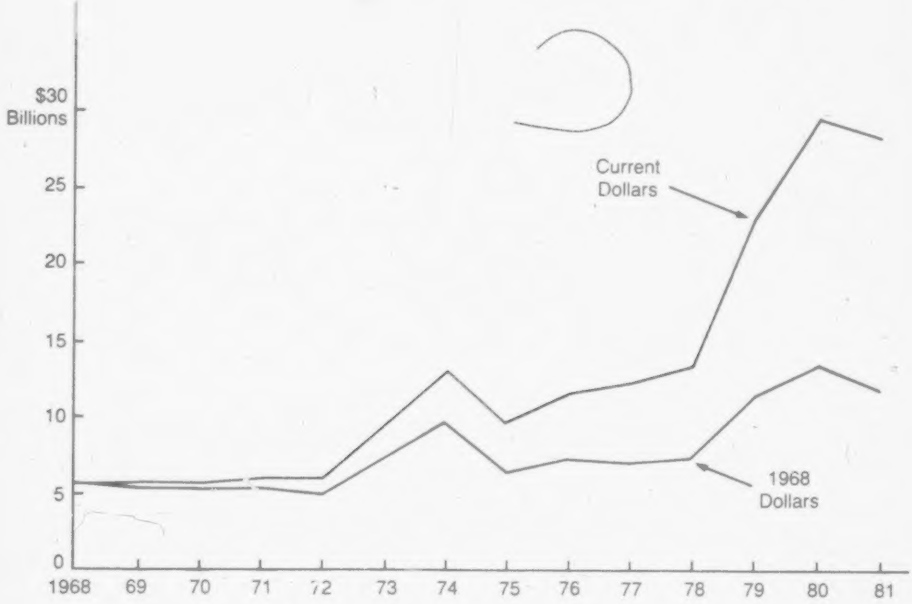
Chart II shows worldwide profits of 25 leading U. S. oil companies for the period 1968-1981. Oil profits have sometimes risen and sometimes fallen, as have profits in other industries. Profits not adjusted for inflation were stable around the $6 billion level through 1972. They then rose to $13 billion in 1974 and fell back to $10 billion in 1975. Profits then increased at a slow pace and reachieved the 1974 level in 1978. Another cycle brought profits to $30 billion in 1980, followed by a decline to $28 billion in 1981 with the pace of decrease accelerating in the second half of the year. While oil profits declined in 1981, non-oil company manufacturing profits were up by 15 to 20 percent.

The lower line in Chart II provides a far more realistic assessment of the long-term importance of oil profits. When the real buying power of a profit dollar is considered, the 1980 profit figure of $30 billion is equivalent to $14 billion in 1968 dollars. The deflation is conservative since it is based on the implicit price deflator for U. S. Gross National Product, which has risen much less rapidly than the cost of oil exploration and production. Exploration and production expenditures account for about two thirds of petroleum capital outlays.

Recent weaknesses in oil profits reflect declining world demand for oil which has caused prices to decline and, thereby, has squeezed profit margins -- see Chart III. Except for the first quarter of 1980, quarterly profits averaged about $7 billion from late 1979 to mid-1981. A drop toward $6 billion began in the third quarter of 1981. Thus, we are observing a repetition of the type of contraction which followed the 1973-1974 market disruption.

Chart II

Worldwide Profits of 25 U.S. Oil Companies, 1968-1981
As Reported in Current Dollars *vs.* Buying Power
Measured in Constant 1968 Dollars*

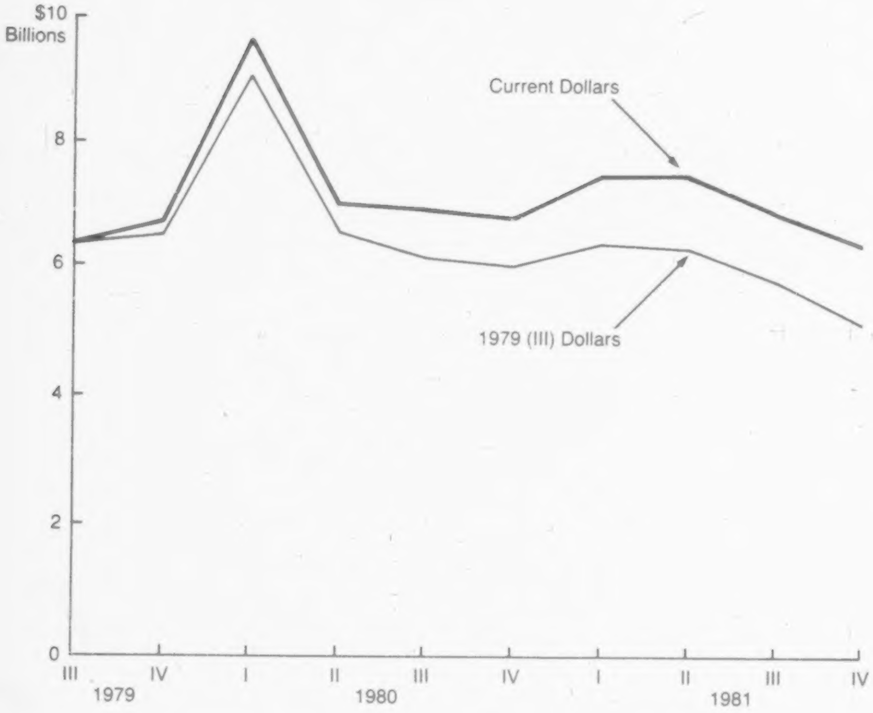


Note: *--Deflated by the implicit price deflator for U.S. Gross National Product.

Source: American Petroleum Institute.

Chart III

Quarterly Profits of 25 Leading U.S. Oil Companies Third Quarter 1979 to Fourth Quarter 1981 (billions of dollars)



Source: American Petroleum Institute Survey.

C. Profitability

The rate of return on investment is a far more significant indicator of an industry's performance than is the absolute level of profits, which ignores the level of investment. More investment creates more profits. Furthermore, return on investment is the only method of comparing one industry's profitability with another. The most widely used measure of return on investment is net income as a percent of shareholder equity.

According to Citibank, worldwide return on equity was higher for non-oil manufacturing companies than for oil companies in three of the five years, 1968-1972--see Chart IV--despite the high degree of risk inherent in petroleum exploration. As oil prices increased in 1973 and 1974, the oil companies' rates of return rose above non-oil manufacturing -- as would be expected given exploration risks. However, oil returns were again below non-oil manufacturing during 1976-1978. Thus, the oil price increases of 1973-1974 only temporarily raised oil industry profitability above other industries.

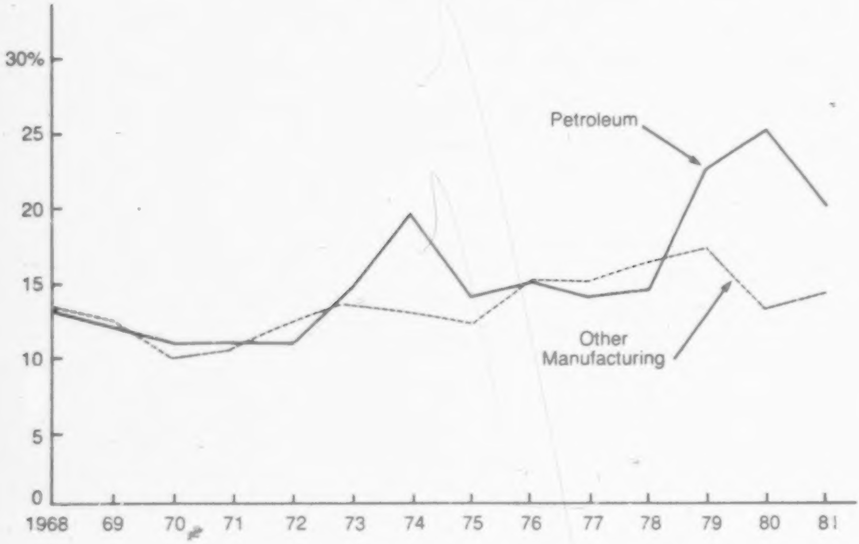
For the two years 1979 and 1980, oil company returns again rose above non-oil company returns. Then, the industry was struck by declining demand and prices in 1981. Consequently, there was a sharp decline in the oil industry's rate of return -- experienced concurrently with an increase in returns for non-oil manufacturing. By the end of 1981, the oil rate of return on historic shareholder investment was below 20 percent with no adjustment for inflation. Returns on costly new projects must be lower.

D. Capital Expenditures

Increased profitability has provided the incentive for substantial growth in oil industry capital spending. It has also provided much of the cash required to finance the new investments.

Chart IV

Worldwide Return on Shareholder Equity, 1968-1981
U.S. Oil Companies *vs.* Other Manufacturing
(Not Adjusted for Inflation)



Source: Survey by Citibank.

While profits were about constant during 1968-1972, capital expenditures were also constant. Between 1972 and 1974, worldwide profits of 25 U. S. oil companies increased from $6 billion to $13 billion (in current dollars); and capital expenditures increased from $10 billion to $19 billion. This was the beginning of a massive increase in petroleum investment reflecting higher profits.

The average level of profits during 1974-1978 was about twice the 1968-1972 level, with capital expenditures also approximately doubled:

	Profits	Capital Expenditures
	------ Billion Dollars ------	
1968-72 Average	$6	$10
	+6	+10
1974-78 Average	12	20
	+18	+21
1980	30	41

By 1980, profits were up by another $18 billion; and capital expenditures were up by $21 billion. The larger absolute increases in capital expenditures were financed by increased borrowing -- the capability for which rises as profits rise.

During the first nine months of 1981, capital expenditures rose by another $20 billion (annual rate) -- despite the leveling and, then, decline in profits. However, investment lags decreased profits because of commitments already made. Current surveys show planned reductions in 1982 expenditures as the long-term correlation between profits and investment takes hold.

The House Democratic Study Group recently asserted that leading oil companies "seemed to be pursuing a strategy of hoarding a large share of the cash flow which decontrol brought them instead of investing it in energy." They contended that only 44 percent of the leading companies' increased funds during 1978-1980 were invested in petroleum projects. This allegation is simply incorrect.

As was shown in Chart I above, leading companies added $38 billion of petroleum assets in 1980 out of a total addition of $48 billion -- about 80 percent. Of the other $10 billion, $3 billion was spent on chemical facilities (a long-standing extension of petroleum refining), $3 billion on other energy sources, and $4 billion on other businesses. Over the period 1974-1980, additions in the "other" category averaged about 6 percent of total.

Of course, additions to plant and equipment are not the only appropriate use of corporate funds. Dividends must be paid to shareholders. Debt must be repaid. And working cash balances must grow with the growth of a company's business. Uses of funds by 25 large companies during 1978-1980 were as follows:

	Billion Dollars	Percent of Total
Capital Expenditures	$ 96	67%
Investments and Advances	17	12
Dividends	21	15
Additions to Working Capital	6	4
Other	3	2
Total	$143	100%

"Hoarding" of funds increased by only $6 billion -- 4 percent of total uses of funds -- in a period when the dollar volume of business skyrocketed as OPEC raised oil prices and shortened credit periods. (During these years, sales revenues rose by three fourths while working capital rose by only one third.) Capital expenditures were about two thirds of the total -- dividends a sixth.

By comparison with other industries, Department of Energy data for 1978-1980 show that 374 non-oil industrial companies used 56 percent of their funds for capital expenditures -- well below the 67 percent shown above for leading petroleum companies. It is clear that the petroleum industry responded promptly and strongly to the dual effects of improved profitability: increased incentive to invest and increased funds to carry out new projects.

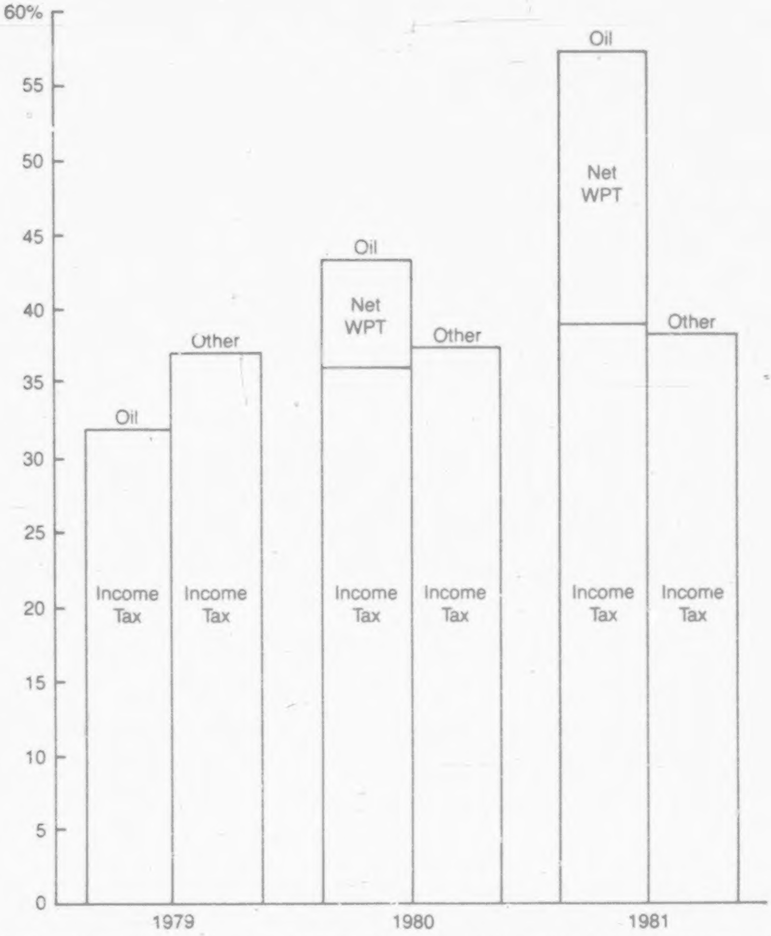
E. Tax Burden

Private investment, responding to relative rates of return, is the most effective method of allocating capital resources throughout the economy. Interference with this process diminishes the economy's efficiency. Thus, taxing petroleum even more relative to other industries would discourage investment just as the country is making encouraging progress in the quest for energy security.

Chart V compares the partial tax burden of the U. S. oil industry and other U. S. companies for 1979, 1980, and 1981. Taxes included are current U. S. federal and state income taxes and the crude oil windfall profit tax. For 1981, the petroleum income tax burden, alone, is comparable to that of other companies -- roughly 38 percent. However, windfall profit taxes have created a dramatic disparity in tax burden -- roughly 57 percent vs. 38 percent. Moreover, the data do not include state severance taxes on oil and gas. The data also exclude "deferred" income taxes (which arise primarily from the difference between accelerated and economic-life cost recovery). These deferred income taxes are highest for industries, such as petroleum, which are investing heavily in new plant and equipment.

Chart V

Current Domestic Tax Burden of U.S. Oil Companies Compared with Other Companies, 1979-1981 (Income and Windfall Profit Tax as Percentage of Income Before Tax)*



Note: *--Oil income taxes shown for 1980 and 1981 are what would have been paid without the Windfall Profit Tax, which is shown net of the income tax offset. In the WPT computational procedure, the WPT is deducted from income; and income tax is levied on the residual. If there were no WPT, the income tax would be higher--as shown above.

Source: American Petroleum Institue and Federal Trade Commission Surveys

II. THE ADMINISTRATION'S PROPOSED CORPORATE MINIMUM TAX

A. In General

The Administration has proposed an alternative Corporate Minimum Tax (CMT) to replace the existing 15 percent add-on tax. The existing tax is equal to 15 percent of certain so-called "preference items" for corporations in excess of the greater of $10,000 or 100 percent of the corporation's regular federal income tax liability for the year. For most corporations, this means the existing minimum tax is payable only where the total preference items exceed the regular federal income tax liability for the year.

Under the current law, no distinction is made in the treatment of preferences resulting from permanent reduction in effective tax rates versus those resulting from mere timing differences in cost recovery. The corporate preference items which result in permanent tax reductions are (1) percentage depletion in excess of the adjusted basis of the property and (2) 18/46 of long-term capital gains. Corporate preference items under existing law which represent mere timing differences are (1) deductions by financial institutions for bad debts in excess of the amount that would have been allowed on the basis of actual experience, (2) the excess of Accelerated Cost Recovery System (ACRS) deductions over 15-year straight-line recovery for real property, (3) the excess of 5-year amortization of certified pollution control facilities over ACRS deductions, (4) the excess of 5-year amortization of railroad rolling stock over 10-year ACRS deductions, and (5) the excess of 5-year amortization of child care facilities over ACRS deductions.

In addition to preferences similar to the above corporate items, the list of preferences for individuals includes (1) the deduction for intangible drilling and development costs (IDCs) to the extent such deduction exceeds the sum of the first year deduction, if any, under 120-month straight-line amortization plus oil and gas net income, and (2) the excess of ACRS deductions over straight-line recovery for certain leased property.

The Administration's new proposed CMT would be computed on taxable income (including capital gains), exclusive of any net operating loss carryovers, plus the sum of the existing corporate preference items (except the railroad rolling stock and 18/46 of corporate long-term capital gains preferences), and a number of new preference items. The new preference items are:

1. The excess of IDCs incurred during the year over a first year amount of 120-month straight-line amortization, with no reduction for existing oil and gas net income and no straight-line amortization after the first year.

2. The excess of mining exploration and development cost deductions over a first year amount of 120-month straight-line amortization, with no reduction for existing income from mining and no straight-line amortization after the first year.

3. The excess of lessor tax deductions under the safe haven leasing provisions of ACRS over the straight-line amortization over the lease term of net cash invested by the lessor.

4. Deductions for interest on indebtedness to purchase or carry tax exempt securities.

5. Deferred Domestic International Sales Corporation (DISC) income.

6. Shipping income deferred through amounts deposited in construction reserve funds or capital construction funds under the Merchant Marine Act.

7. Amortization of motor carrier operating rights.

8. The excess of interest deducted on original issue discount bonds over the amount that would have been deductible if the interest were computed on an actuarial basis at the interest rate equal to the yield at which the bond was issued.

9. The excess of deductions allowed for certain indirect costs incurred for long-term contracts entered into before February 26, 1982, over the amount that would be allowed under the proposed new progress payment method of accounting rules.

The Administration's proposal would erect a barrier to new investment for those taxpayers which may be placed in a minimum tax position due to depressed earnings or a substantial investment program. For such taxpayers, the current after-tax cost for each dollar of incremental investment would increase from $.54 under present law to $.85 for non-preference expenditures and to $1.00 for preference items. See Exhibit A.

As long as a taxpayer remains subject to the CMT instead of the regular income tax, the effect of treating many of the deductions as preference items is denial of any tax deduction for incremental expenditures or investments. The taxpayer would be in a worse position than if it had not been permitted (or required) to claim an accelerated deduction. This results from the failure of the proposal to recognize any cost recovery for timing preferences other than in the year of the "preference". Such failure to allow full cost recovery under the "non-preference" standard would cause many corporations to incur a CMT liability even though their effective federal income tax rates are well above the CMT rate. Thus it is obvious that the CMT would tax recovery of capital as well as economic income. See Exhibit B.

The Administration's proposed CMT would also not allow the investment tax credit (ITC) to be used as a credit against the CMT. Thus, as long as a taxpayer remains subject to the CMT, all current benefit of the ITC would be lost on incremental investment, as noted in Exhibit B. This would frustrate the goals under the Economic Recovery Tax Act of 1981 (ERTA) to encourage new business investment in plant and machinery, and slow or even preclude recovery in many depressed industries.

A special CMT credit measured by the excess of CMT over regular tax would be applied against the regular tax in subsequent years. However, this CMT credit appears to provide no relief so long as a taxpayer remains in a CMT position.

Passage of the new corporate minimum tax would be a long stride away from the goal of administrative simplicity. Two independent, but alternative tax systems will affect the corporation's investment decisions. The consequences of an investment decision would have to be reviewed with respect to the two taxes simultaneously. This type of "two-track" analysis would impose additional uncertainty and complexity under the Administration's accelerated estimated tax proposal as well. Further, a non-deductible penalty (as opposed to a deductible interest charge) on underpayments would force taxpayers to overpay their estimated tax liability.

The CMT proposal does provide for a limited foreign tax credit (Minimum FTC) as the only available credit against the CMT. This Minimum FTC is based upon a recognition of international tax principles designed to eliminate double taxation among countries as well as possible problems with existing tax treaties if such credit were not provided.

The Minimum FTC does not address those taxpayers who either elect to deduct foreign taxes in computing regular taxable income; or have "overall foreign losses" as a result of recent entry into foreign operations or undertake heavy foreign exploration and development programs. Such taxpayers apparently would pay CMT on foreign preferences currently without subsequent benefit of such CMT payments as an offset to tax when such "overall foreign losses" are recaptured, all as more fully discussed below.

B. Intangible Drilling and Development Costs

Background

Over the past years, a significant amount of attention has been directed to the current deduction of "intangible drilling and development costs." Despite this previous consideration, the history, nature and impact of the option to deduct such costs is sometimes overlooked. Inasmuch as the Administration's minimum tax proposals could adversely impact the economic viability of oil and gas drilling operations, we believe that it is important to reexamine briefly the nature and tax treatment of intangible drilling and development costs as a predicate to our comments in opposition to the proposal.

Under the Treasury Regulations, an intangible drilling and development cost (hereinafter "IDC") is any cost incurred that in itself has no salvage value and that is "incidental to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas."* (Treas. Reg. Sec. 1.612-4) Such costs expressly include wages, fuel, repairs, hauling, supplies, etc., which are incurred in the drilling of wells, in the clearing of ground, and in the construction of derricks, tanks and other physical structures that are necessary for the drilling of wells and the preparation of wells for the production of oil or gas.

For income tax purposes, IDCs are capital in nature and, as such, would ordinarily be taken into account through allowances for cost recovery. Section 263(c) of the Internal Revenue Code, however, provides an exception to this general rule whereby the taxpayer has the option to deduct such costs currently. Under the option, only the holder of a "working" or an "operating" interest (i.e. the interest which is burdened with the risks and costs of developing and operating the property) may currently deduct IDCs. Moreover, the election to deduct IDCs must be made by the taxpayer for the first taxable year in which such costs are incurred and is binding for all subsequent years.

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* For simplicity purposes, our comments are made with specific reference to oil and gas IDCs. Our views also are intended to encompass geothermal IDCs.

The option to deduct IDCs for income tax purposes is not of recent origin. Although no specific statutory authority existed for the deduction of IDCs until 1954, the election was first made available by administrative ruling in connection with the Revenue Act of 1916. T.D. 2447, issued February 8, 1917, reads as follows:

> The incidental expenses of drilling wells, that is, such expenses as are paid for wages, fuel, repairs, etc., which do not necessarily enter into and form a part of the capital invested or property account, may, at the option of the individual or corporation owning and operating the property, be charged to property account subject to depreciation or be deducted from gross income as an operating expense.

Furthermore, the Revenue Acts of 1918 and 1921 implicitly indicate that Congress considered IDCs to be deductible. (Revenue Act of 1918, Sec. 214(a)(1); Revenue Act of 1921, Sec. 214(a)(1))

Initially, the tax treatment of IDCs was influenced by the fact that many taxpayers considered the expensing of such costs to be an acceptable accounting practice. The treatment was also justified as a means of encouraging the exploration and development of our Nation's natural resources. Although accounting practices and theories may have changed over the years, the policy to develop our Nation's mineral resources still supports the need for rapid recovery of IDCs for tax purposes. The element of high risk is still present inasmuch as oil and gas deposits have become even more difficult to find. Additionally, the costs of drilling have escalated in response to greater logistical and technological problems which are encountered today as the industry drills in more hostile offshore and frontier environments.

IDCs As An Item of "Tax Preference"

Under present law, the amount by which the "excess IDCs" exceed the net income from oil and gas properties during the year is a so-called "tax preference" item for individuals. (I.R.C. Sec. 57(a)(11)) "Excess IDCs" are deductible IDCs incurred during the taxable year less the amount, if any, that would have been deductible in the same year if the taxpayer had amortized the expenses for that year over 120 months beginning with the month of first production (or, if the taxpayer so elects, less the amount of cost depletion that would have been deductible rather than the 120-month amortization). Since only the first year's allowance for cost recovery is recognized for minimum tax purposes, the amount of the IDC preference is substantially overstated. The IDC tax preference under current law, however, does not apply to corporations with the exception of personal holding companies and Subchapter S corporations.

IDCs first became an item of tax preference in 1976 as part of a major legislative attack on "tax shelters". The efforts of Congress were directed, however, to individual "tax shelter" investors and not to corporations or to individuals in the business of exploring for and developing oil and gas. This intent was clearly demonstrated when the offset for net income from oil and gas properties was added by the Tax Reduction and Simplification Act of 1977 (P.L. 95-30) and the Revenue Act of 1978 (P.L. 95-600). The offset was considered necessary because the 1976 rules penalized individuals in the business of exploring for oil and gas. Moreover, Congress was concerned that without the net income offset, serious economic distortions could result especially with regard to marginal wells. The following example which was inserted in the *Congressional Record* by Senator Bentsen, one of the sponsors of the modification, demonstrates the intent of Congress that the minimum tax on IDC was not intended to penalize producers.

> Example: An independent producer, with substantial oil and gas income, had spent $350,000 in IDCs drilling a well. It would have cost $85,000 to complete the well. The producer estimated a net income of $2,000 a month from the well and would have completed it, expecting a payout of the completion costs in 41 months and a profit (if IDCs are ignored) over the eight-year life of the well. But *the minimum tax on IDCs totally changed*

> *the picture* because a minimum tax of 15 percent of the IDCs ($52,500) would be due. Because the minimum tax isn't deductible in computing the producer's income tax liability under Section 1, he would pay $52,500 from after-tax income, which would require pre-tax profits of $175 000 from the well. *On those assumptions, the well couldn't make a profit and was plugged as a dry hole.* (123 Cong. Rec. Page S6702 daily ed., April 28, 1977; Emphasis Added)

Administration's Proposal on IDCs

Under the Administration's proposal, IDCs would become a tax preference item subject to the proposed alternative minimum tax for corporations. The IDC tax preference amount would equal the deduction of IDCs for the taxable year in excess of the amount allowable in the year incurred, if such costs had been capitalized and amortized on a straight line basis over 120 months beginning with the month of first production. If there is no production during that year, no offset for cost recovery is ever allowed. (See Table A, below.) Unlike the IDC preference item rules for individuals, there is no offset for the net income from oil and gas properties. Furthermore, the Technical Explanation does not mention a "tax benefit rule" similar to that afforded individuals (see I.R.C. Sec. 56(b)) or other provisions usually associated with existing timing preference items.

The API respectfully submits that the treatment of IDCs as a preference item under the Administration's corporate minimum tax proposals is unwarranted and counterproductive for the following reasons:

(1) *The Treatment Of IDCs Does Not Constitute A Tax Preference Per Se Especially When Compared To The Treatment Afforded Other Capital Costs Under The Accelerated Capital Cost Recovery System ("ACRS")* - In determining whether an item of deduction properly constitutes a "tax preference", the tax treatment afforded the item subject to scrutiny should be compared to the tax treatment afforded other generically similar items which do not constitute items of tax preference. In the case of a timing preference item, the item under scrutiny may properly be considered a tax preference only if the tax treatment afforded such item significantly reduces the present value of the taxpayer's after-tax costs when

compared to the treatment afforded non-preference items. Under this type of analysis, the tax treatment of IDCs should not be considered a tax preference.

Treatment of IDCs as a preference fails to recognize that on a present value basis, current expensing of capital costs is not appreciably different from the sum of recovery under the ACRS for 5-year property, and the 10 percent investment tax credit (ITC). Comparing the tax treatment of IDC to that of depreciable property under ACRS is consistent with the views of Congress previously expressed regarding capital cost recovery (see (2) below)and is conceptually proper under recognized tax accounting principles notwithstanding Treas. Reg. Sec. 1.612-4(b).*

For example, similar types of costs (i.e. wages, fuel, repairs, hauling, supplies, etc.) which are capital in nature and which are associated with the construction of assets which fall outside the parameters of the IDC option would be considered depreciable property eligible for ACRS (e.g. the costs of drilling a water source well to be used solely for secondary recovery operations). Moreover, such costs are capitalized and recovered through allowances for depreciation under generally accepted accounting principles for financial statement purposes. (See Financial Accounting Standards No. 19, p. 13.) Accordingly, any IDC "preference" should be measured in terms of 5-year ACRS plus 10 percent ITC. Under this type of analysis, it becomes clear that the current expensing of IDCs subject to the CMT is less favorable than ACRS or even the earlier 11-year ADR depreciation schedule for oil and gas production equipment, plus the 10 percent ITC. The following table illustrates this point:

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*The current treatment of capitalized IDC as a depletable investment under Treas. Reg. Sec. 1.612-4(b) is not based on sound tax accounting theory, but on a questionable IRS interpretation of the discovery value depletion provisions of the Revenue Act of 1918. IDCs were originally treated as depreciable investment if the taxpayer did not elect to deduct them currently. (T.D. 2447, February 8, 1917.) With the advent of discovery value depletion in 1918, the IRS changed its position and contended that the depletable value of the well included capitalized IDC except to the extent they were represented by physical property which was still considered depreciable. (Regulations 45, Art. 223.) The IRS continued to take the same position after percentage depletion was substituted for discovery value depletion in 1926. (Treas. Reg. Sec. 1.612-4(b) -- current regulations.) With repeal of percentage depletion on most production, there clearly is no logical basis for characterizing even a portion of IDC as depletable investment.

Table A

Present Value After Tax Cost of $1,000 of Intangible Drilling and Development Costs (IDC) at a 15% Discount Rate

	Expenditure	Current Year: Deduction	Effect on Federal Income Tax @ 46%	Cost After Federal Income Tax	Present Value After Tax Cost @ 15% Discount
1. Current Law to Corporations	$1,000	$1,000	$460	$ 540	$ 540
2. 5-Year ACRS:	1,000				1,000
ITC			100		(100)
Year 1		150	69		(69)
Year 2		220	101		(88)
Year 3		210	97		(73)
Year 4		210	97		(64)
Year 5		210	96		(55)
		1,000	560	440	551
3. 11-Year ADR DDB/SYD with ITC	1,000	*	560	440	610
4. IDC-Current Deduction Subject to CMT	1,000	1,000	0**	1,000	1,000

*Detail of depreciation deductions not shown for purposes of simplicity.

**Recognizes that the 120-month amortization offset would not be available if production commences in subsequent year, which is usually the case.

(2) To Treat IDCs As An Item Of Tax Preference Is Inconsistent With The Stated Views Of Congress Concerning Capital Cost Recovery - The imposition of a minimum tax on IDC effectively erodes the ability of taxpayers to recover capital costs and is inconsistent with the conclusions reached by Congress during its consideration and adoption of the Economic Recovery Tax Act of 1981 (P.L. 97-34, H. R. 4242) Indeed, the key issue in the debate on H. R. 4242 relating to the need for an improved capital cost recovery system was whether the cost of most machinery and equipment should be expensed instead of recovered over five years with a 10 percent ITC.

The report of the Committee on Ways and Means on its version of H. R. 4242 explained the advantages of current expensing over deferred cost recovery as follows:

> Deductions spread over a term of years are eroded by inflation, reducing their real value, the profitability of investment and hence the incentive to invest. This tax reduction program should provide for expensing. This simple depreciation rule gives the maximum acceleration of depreciation deductions, insulates these deductions from the adverse effects of inflation and eliminates tax incentives to make inferior investments. (H. Rpt. 97-201, at page 17, H. R. 4242.)

Although Congress ultimately chose the 5-year Accelerated Cost Recovery System (ACRS), for most equipment, current expensing was clearly accepted as the standard against which any capital recovery system should be measured.

During its deliberations on H. R. 4242, the Congress reviewed the existing treatment of IDC expenditures and declined to make any changes in present law. Thus, the retention of the option to deduct currently the IDC portion of the cost of an oil or gas well (without a minimum tax) is supported by recent Congressional action and the statement in the Report of the Committee on Ways and Means on H. R. 4242 as quoted above.

The current deductibility of IDCs embodies this standard for tax efficiency and neutrality. The real value of expenditures on intangible drilling and development is not eroded by inflation. Deducting IDC does not eliminate any tax liability for oil and gas producers, nor does it impose any long-range reduction in federal tax receipts. Moreover, existing law provides for the "recapture" of certain IDC expenditures as ordinary income where taxpayers make early disposition of oil and gas properties at a gain. Therefore, the current deduction of IDC is approximately the same as recovery under ACRS with the 10 percent ITC. Hence, there is no economic justification for penalizing producers through the imposition of a minimum tax on IDCs.

(3) To Treat IDCs As An Item Of Tax Preference May Result in Economic Distortions Not In Furtherance Of The Nation's Energy Policy - The search for new oil and gas reserves entails high-risk, capital-intensive operations. The right to deduct IDC expenditures is important to the national effort to find and develop increased domestic petroleum supplies. Diluting this deduction through the imposition of a minimum tax would hamper the search for new oil and gas reserves over the next several years. Once a taxpayer becomes subject to CMT, it is effectively denied any current tax deduction for incremental investment in IDC, which will restrain additional drilling and reduce available reserves and production.

(4) The Administration Proposal Pertaining To IDCs As An Item Of Tax Preference Contains Numerous Defects and Omissions -

(a) Failure to provide an offset for net income from oil and gas properties similar to that provided to non-corporate taxpayers would impose a tax penalty on completing oil and gas wells and would reduce oil and gas drilling efforts. The failure to include an offset mechanism is inconsistent with the legislative actions taken by Congress in 1977 and 1978 as explained earlier in our comments. In summary, such an omission constitutes a penalty on corporate producers engaged in oil and gas exploration and development and is contrary to the Nation's energy goals.

(b) The Administration's proposal fails to provide taxpayers with a new opportunity to forego IDC tax preference deductions through a property-by-property election to treat IDCs as 5-year recovery property under ACRS and also eligible for ITC. As a result, the proposal is not consistent with the elections accorded taxpayers on other existing timing preference items.

(c) As with other timing preferences, no allowance is made for cost recovery beyond the first year in calculating the amount of the IDC preference. Additionally, corporate taxpayers apparently would not be entitled to use the "tax benefit rule" currently available to non corporate taxpayers.

Conclusion

The inclusion of IDCs as an item of tax preference subject to minimum tax would sacrifice important long-range economic and energy security goals merely to accelerate the collection of federal revenues. To the extent that IDC expenditures are reduced, discoveries of new reserves and enhanced production efforts in existing fields would decline, and in the long term, profits and tax revenues would decrease. Moreover, there is no sound conceptual basis for treating IDCs as a "preference" deduction. Accordingly, the API urges that Congress exclude from any minimum tax proposals the treatment of IDC as an item of tax preference.

C. Percentage Depletion

The excess of allowable percentage depletion over the adjusted basis of the property at year end would also be included as a preference item under the CMT. As under the existing minimum tax for corporations, the measure of the so-called tax preference for percentage depletion fails to recognize the impact of inflation on the recovery of depletable costs incurred in locating and acquiring oil and gas properties. Measured against current expensing as the clearly accepted standard for any capital recovery system, cost depletion falls far short of providing adequate recovery of real costs or recognition of replacement costs. As a result, the nominal profits of oil and gas producers are substantially overstated and taxation of phantom income is inevitable.

To the extent it is still available to corporate independent producers, percentage depletion based on wellhead prices tends to mitigate this problem somewhat by more nearly reflecting the current replacement cost of existing oil and gas reserves and moving closer to an accurate measure of real net income to the producer. Therefore, the inclusion of percentage depletion as a tax preference is unwarranted and inappropriate.

D. Foreign Operations Under the Proposed Minimum Tax

Background

In light of the adverse competitive effect of international double taxation, the foreign tax credit has remained in the United States tax law and has been accepted as a basic international principle in tax treaties and tax laws of most developed countries. As with any tax provision, there have been changing notions embodied in various Federal Revenue acts as to the mechanics for calculating the foreign tax credit; but the basic principle has always been retained that United States taxpayers should not be double-taxed by the United States on foreign-source income to the extent such income has already been taxed by the country in which the income is earned. If the United States were to deviate from this principle and attempt to impose an additional tax on foreign income, it would make U. S.-based companies non-competitive in the international business sector. The avoidance of international double taxation and the continuance of international competitiveness are traditional tax concepts that are threatened again under the proposed alternative corporate minimum tax (CMT).

Impact on Foreign Operations

The Treasury Department's technical explanation describes the tax base upon which the proposed CMT for the taxable year would be calculated as the sum of "regular" worldwide taxable income (excluding net operating loss carrybacks and carryovers) plus the worldwide items of tax preference. After applying the CMT rate to this base, no credit is allowed other than a limited foreign tax credit (Minimum FTC). The allowable Minimum FTC is computed separately under a limitation formula expressed as -

$$\frac{\text{foreign source CMT base}}{\text{worldwide CMT base}} \times \text{CMT} = \text{allowable Minimum FTC}$$

The effect of this formula is to limit the maximum amount of creditable foreign taxes to that portion of the CMT attributable to the foreign-source CMT base. Additionally, for petroleum industry taxpayers, further limitations regarding foreign tax credit against foreign oil and gas extraction income, foreign oil related income, and other taxable income are applicable with reference to the respective foreign and worldwide CMT bases and the CMT rate is applied instead of the regular U. S. income tax rate. No carryover or carryback of any excess Minimum FTC would be allowed.

Adverse Effects of CMT on Foreign Operations

The imposition of CMT on foreign operations is clearly inconsistent with the recognized principles of tax policy designed to prevent international double taxation and would render U. S.-based companies economically non-competitive in international markets.

(1) Acceleration of U. S. Tax on Foreign Operations Renders U. S. Companies Non-Competitive.

In bidding against non-U. S. companies for foreign operations, U. S.-based companies must be competitive while realizing an acceptable rate of return on investment. During periods of significant investment when little or no income is being earned, CMT effectively taxes preference expenditures. Because expenditures are taxed, CMT potentially imposes an additional, accelerated cost for remaining in foreign operations which foreign competitors would not incur. See Exhibit C.

As indicated in Exhibit C, the U. S. taxpayer theoretically could pay the same total U. S. tax on such foreign operation over a period of several years. However, acceleration in current U. S. tax payments under CMT when netted against the present value of future U. S. tax reductions, if any, effectively creates a current additional cost. That cost would render the taxpayer non-competitive in foreign operations. The initial decision to compete for a foreign project is generally measured by a minimally acceptable rate of return. If the taxpayer must cover the additional U. S. tax cost to maintain such rate of return, it can expect to lose the bid to another company not having such additional cost.

(2) CMT Penalizes Taxpayers for Section 904(f) Recapture of Prior Overall Foreign Losses.

Generally, an "overall foreign loss" occurs when gross income from foreign sources is exceeded by the sum of the deductions properly apportioned or allocated to such income. Although such a loss initially offsets U. S.-sourced income, it is subject to "recapture" in subsequent years. The recapture of the resulting timing benefit of such loss is affected by treating all or a portion of future foreign-sourced taxable income (up to an amount equal to the cumulative total of overall foreign losses in prior years) as income from U. S. sources.

The recapture of overall foreign losses is usually accomplished in one of two ways once the taxpayer moves to an overall foreign income position:

(a) The taxpayer may continue to elect to deduct foreign taxes paid or incurred on such foreign profits, thereby currently paying U. S. income tax on the resulting taxable income until such income offsets the prior accumulated foreign losses. After fully offsetting such losses, the taxpayer would ordinarily then elect to begin crediting foreign taxes against U. S. income tax, thereby eliminating subsequent double taxation of such foreign-sourced income; or

(b) The taxpayer immediately elects to claim foreign taxes paid or accrued on such foreign profits as a credit against U. S. income tax, in which event the lesser amount of accumulated foreign losses or 50 percent of foreign income (100 percent in the case of certain dispositions) is treated as U. S.-sourced income subject to U. S. income tax without benefit of the elected foreign tax credit until such losses are fully recaptured.

Regardless of which of the above methods is employed, the Administration's proposal would appear effectively to levy a CMT on overall foreign losses incurred prior to the effective date of CMT. The Administration's proposal could be construed to preclude a taxpayer from claiming Minimum FTC against CMT if it deducted foreign taxes in computing regular U. S. income tax. Similarly, those taxpayers recapturing overall foreign losses via the foreign tax credit mechanism would also be subject to CMT on pre-CMT foreign losses should section 904(f) recapture rules be applied to the CMT base.

Payment of CMT solely by reason of recapture of prior foreign losses places the taxpayer in a non-competitive position. These recapture problems could be resolved by making section 904(f) recapture inapplicable to pre-CMT overall foreign losses and granting the taxpayer a separate election to deduct or credit foreign taxes for CMT purposes.

(3) Necessity of Foreign Tax Credit Against CMT.

If a taxpayer reaches the position of having sufficient, creditable foreign taxes to offset U. S. tax on foreign-sourced income and preferences, the Minimum FTC under the Administration's proposal appears to safeguard against further international double taxation. However, once in such a position, anything less than a credit for foreign taxes against CMT (for example, a required deduction of foreign taxes in calculating CMT) creates multiple taxation of foreign operations and renders the U. S.-based taxpayer non-competitive.

Conclusion

The introduction of CMT under the Administration's proposal raises serious tax as well as national energy, security, fiscal and other policy concerns. As described above, when CMT operates to subject U. S.-based companies to international double taxation of foreign operations, such taxpayers cannot compete with companies whose incomes are taxed only once. Accordingly, the resulting economics from double taxation would preclude U. S.-based companies from expanding foreign operations and would force their withdrawal from existing foreign operations.

With particular reference to the U. S. energy situation, U. S. needs for foreign supplies of crude oil will continue for the foreseeable future. If U. S.-based petroleum companies are economically barred from foreign crude oil exploration and production, this country would become dependent not merely upon foreign supplies but upon foreign suppliers. Finally, the inability of U. S.-based petroleum companies to enter into, to continue, and to expand foreign petroleum operations due to non-competitive costs may well result in a significant reduction of world crude oil production and reserves, creating higher market costs for energy in the United States, affecting U. S. exports adversely, and impairing the U. S. balance-of-payments position.

CONCLUSION

Overall, the CMT like its predecessors is a poorly conceived attempt to raise additional revenue under the guise of fairness. In effect, it is a tax on corporate investment, and in many instances will tax the "beneficiary" of tax preferences at rates higher than if no preference existed. The impact of the CMT is counterproductive to the goals to spur business investment contained in ERTA.

Exhibit A

THE EFFECT OF THE CMT ON THE AFTER-TAX COST OF DEDUCTIBLE EXPENDITURES

			Case After Reaching CMT Threshold -	
	Base Case	Base Case Plus Incremental Preference Expenditures of 100x*	Incremental Non-Preference Expenditures of 10x	Incremental Preference Expenditures of 10x
Taxable Income (Includes 300x of "Preferences" Before Incremental Expenditures	$200x	$100x	$90x	$90x
Regular Tax @46% Rate	92x	46x	41.4x	41.4x
CMT Base (Taxable Income plus Preferences	500x	500x	490	500
CMT @15% Rate	75x	75x	73.5	75x
Tax Liability (Greater of Regular Tax or CMT)	92x	75x	73.5	75x
After Tax Cost of Each Dollar of Deductible Expenditure:				
$ of Expenditure	$1.00	$1.00	$1.00	$1.00
Per $ Reduction of Tax	.46	.17**	.15**	-0-
After Tax Cost	.54	.83	.85	1.00

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*The result would not change even if the incremental expenditures of 100x give rise to a 90% return on invested capital in the first year which is highly improbable.

**Amount of tax decrease as a result of each dollar of incremental expenditure - ($\frac{92-75}{100}$ = .17) and ($\frac{75-73.5}{10}$ = .15), respectively.

Exhibit B

ADVERSE IMPACT OF CMT ON INVESTMENT

The Corporate Minimum Tax (CMT) effectively denies any deduction for cost recovery of preferences as long as a taxpayer is in a CMT status, and places the taxpayer in a worse position than if no preference existed. The taxpayer in the example below would pay the same aggregate tax over the five year period even if it makes an additional $1,000 investment in drilling (IDC), which would reduce its tax under current law by $460 over the five year period. If the taxpayer were permitted to avoid the preference and use the same five year Accelerated Cost Recovery System (ACRS) available for tangible well investment, recovery of cost would be recognized to some extent for tax purposes, although 2/3 of the benefit of ACRS would be lost ($460-150). It should also be noted that the CMT destroys any benefit from the 10 percent investment tax credit. Thus, the CMT would erect a substantial barrier to new investment by anyone unfortunate enough to fall within its trap.

	Taxable Income	Preferences	CMT Base	Regular Tax @46%	CMT @15%	Tax Payable
Base Case						
Years 1-5 (each)	1000	3000	4000	460	600	600
Total	5000	15000	20000	2300	3000	3000
Spend $1000 on IDC in Year 1						
Preference Treatment - Current Expensing						
Year 1	-0-	4000	4000	-0-	600	600
Years 2-5 (each)	1000	3000	4000	460	600	600
Total	4000	16000	20000	1840	3000	3000
Reduction in Tax for Cost Recovery				(460)	-0-	-0-
Non-preference Treatment - ACRS & ITC						
Year 1	850	3000	3850	291*	578	578
2	780	3000	3780	359	567	567
3	790	3000	3790	363	569	569
4	790	3000	3790	363	568	568
5	790	3000	3790	364	568	568
	4000	15000	19000	1740	2850	2850
Reduction in Tax for:						
Cost Recovery				(460)	(150)	(150)
ITC				(100)	-0-	-0-

* $391 less $100 ITC

EXHIBIT C - Page 1

ACCELERATION OF U. S. TAX ON FOREIGN OPERATIONS

ASSUMPTIONS: Taxpayer has oil and gas production operations in the United States and Foreign Country X. Both the United States and Country X operations have been profitable. Taxpayer has been electing the foreign tax credit in computing U. S. income tax.

YEAR 1: In the year CMT becomes effective, taxpayer launched a large drilling program (committed to before enactment of the CMT) in Country X, thereby throwing his foreign operations into a loss for the year.

YEAR 2: Taxpayer's operations in Country X again return to a profit and taxpayer pays $200 in foreign income tax. He also elects the foreign tax credit and recaptures all of his Year 1 foreign loss in computing U. S. income tax and CMT.

YEAR 3: Taxpayer's U. S. and Country X income and preferences remain at Year 2 levels.

YEAR 4: Taxpayer reduces his tax preferences, thereby increasing his income subject to U. S. income tax. Taxpayer pays $250 of foreign income tax.

Summary of CMT Effect on Cash Flow

Year	Tax Paid W/O CMT	Tax Paid With CMT	Cash Flow Difference	Accumulated Cash Flow
1	92	300	(208)	(208)
2	266	210	56	(152)
3	184	180	4	(148)
4	322	174	148	-0-
	864	864	-0-	

NOTE: At the end of year 3, taxpayer would have paid a total of $542 if no CMT existed. With CMT, taxpayer has paid a total of $690 over the first three years for a cash flow deficit of $148. If taxpayer's income and preferences remained constant at year 3 levels, it would take taxpayer 37 years to break even on cash flow (before discounting). However, if the CMT carryover was applied to the regular income tax only to the extent needed to reduce the income tax to the CMT level, the 15 year carryover would expire with the taxpayer picking up only $52 of the $148 cash flow deficit at end of year. For this reason, it is very important to assure that the CMT carryover works as shown in the following examples.

EXHIBIT C - Page 2

Year	Source		Income Base		Pref-erence		CMT Base	
1	United States		400		800		1200	
	Foreign		(200)		1000		800	
	Worldwide		200		1800		2000	
	Tax	@ 46% -	92			@ 15% -	300	Carryover 208 (300-92)
2	United States		400		800		1200	
	Foreign		400		600		1000	
	Worldwide		800		1400		2200	
	Tax Before FTC	@ 46% -	368			@ 15% -	330	
	FTC		(92)	46% of 200 (400-200)			(120)	15% of 800 (1000-200)
			266				210	
	CMT Carryover		(208)				N/A	
	Tax		58				210	Carryover 152 (210-58)
3	Same Income and Preference as Year 2 - Worldwide		800		1400		2200	
	Tax Before FTC	@ 46% -	368			@ 15% -	330	
	FTC		(184)	46% of 400			(150)	15% of 1000
			184				180	
	CMT Carryover		(152)				N/A	
	Tax		32				180	Carryover 148 (180-32)
4	United States		700		400		1100	
	Foreign		500		500		1000	
	Worldwide		1200		900		2100	
	Tax Before FTC	@ 46% -	552			@ 15% -	315	
	FTC		(230)	46% of 500			(150)	15% of 1000
			322				165	
	CMT Carryover		(148)				N/A	
	Tax		174				165	Carryover -0-

REMARKS BY THE NATIONAL TOOLING & MACHINING ASSOCIATION

Mr. Chairman and members of the committee, the members of the National Tooling & Machining Association are manufacturers and small businessmen. The average size of the 12,000 to 14,000 businesses in this industry is 26 employees. The importance of this industry is that it literally provides the means of all manufacturing production. Before any product can be manufactured, our members must provide the tooling, dies, molds, jigs, fixtures, gages, automated machines, and precision production parts necessary for mass-production.

The Congress and the administration are facing some very difficult choices. Despite significant reductions attained in federal spending and the rate of inflation, our country currently faces high interest rates, high unemployment, and projected Federal deficits of enormous magnitude. The decision we face is whether to live with the deficits or try to reduce them by either further cutting spending, increasing taxes, or both.

We believe that the Federal deficit must be reduced. Deficit spending results in higher interest rates as the Federal Government competes with the private sector for available money.

High interest rates are having the most telling effect on small businesses. These businesses lack the ability to provide their own financing through the issuance of corporate bonds and they find that they must pay more than the prime rate for business expansion loans. High interest rates undermine the confidence both individuals and businessmen have in our country's ability to return to robust economic health. Resulting negative expectations in terms of future Federal deficits and their effect on interest rates further compounds the problem.

These factors point to the need to reduce the Federal deficit to a more reasonable level. There is no magic number, but we would suggest that a fiscal 1983 deficit of $50 billion or less, with further reductions in ensuing years, might be enough to reduce competition in the loan markets and instill a greater confidence in both individuals and the business community.

Of concern to all of us is how these deficit reductions are to take place. We believe the reductions will have to come mostly from further budget reductions. On the tax side, we would suggest that you hold inviolate recent changes in depreciation rates, corporate taxes, and estate taxes. On the budget side, we would suggest that no area be held inviolate but that our defense budget not be cut until every last penny has been squeezed out of other budgets.

There are many possible budget options available in the February 1982 CBO publication "Reducing the Federal Deficit: Strategies and Options." Among some of the proposals that merit further consideration, and the revenue figures associated with them, are:

Budget reductions which would reduce deficit, fiscal year 1983 [1]

	Billion
Make States pay 20 percent of food stamp costs	$2.2
Reduce COLA for social security from 100 percent 67 percent of CPI to	5.2
Raise medicare premium (physician segment)	3.7
Raise medicare premium (coinsurance payment—hospital services	1.9
Eliminate nonmortgage consumer interest payment deduction	1.9
$0.50 Barrel energy tax	2.9
Medicare beneficiaries to pay 10 percent of patient's first month deductible	1.1
Tax employees on employer-paid health insurance (income & payroll)	2.6
Cover new Government employees under social security	.3
Eliminate deductibility of State and local sales taxes	.8
Tax Federal employees for Medicare	.7

[1] Assumes proportionate yearly savings for multi-year proposals.

We believe that significant additional budget savings could be achieved by reducing the COLA on Federal pensions and by prohibiting double and triple dipping on both social security and Federal pensions. Reforms in depreciation rates, corporate tax rates, and estate taxes should not be made because we continue to feel that these taxes will spur productivity and enable this country to again become competitive both domestically and internationally. We agree with the administration that these reforms are necessary and will work.

Those who have decried these reforms as unsuccessful because there has not been a major increase in business investment in the short time the law has been in effect have a misunderstanding of the business investment process and the current environment. Major corporations make their investment decisions on a long-term basis, very often in a planning process of five years. These plans can be modified, of course, but it can still easily take two years from the moment of decision to the purchase and installation of equipment and facilities resulting from such a decision. Small businesses can be, and are, much more flexible in terms of investment decisions. The things holding small businesses back at the moment are consumer demand and interest rates. Interest rates are so high that they discourage consumers from spending. The resulting soft demand combined with the effect of the same interest rates on small businesses has temporarily negated the incentive of the recent tax cut. Reducing the Federal deficit will lick the interest rate problem. We are confident that there will then be increased consumer spending and major investment by all segments of the business community.

We suggest that deficit reductions be achieved primarily through further budget cuts. In modifying business taxes, we suggest that they be changed so as to have the least impact on the small business community. There are several reasons for this request. First of all, small businesses have been the hardest hit by the current recession, as attested to by the recent alarming increases in bankruptcy in this sector. Secondly, small businesses have the greatest capacity to lead the country out of the recession. Their investment and hiring decisions can be made and implemented very quickly. Thirdly, small businesses can solve the problem of unemployment as they help with economic recovery. Small businesses have been credited with creating as many as 90 percent of all new jobs. These new jobs simultaneously reduce Federal transfer payments and expand the tax base.

It is with deep regret that we must conclude that the majority of the administration's tax proposals, while admirable in intent with respect to the Federal deficit, are not appropriate. Enactment of completed contract proposals will result in a law with complicated rules as well as higher prices since businesses will adjust prices to reflect the change in cash flow created by earlier tax payments. Nor is a corporate minimum tax a good idea, for businesses use profits for investment and job creation. A corporate minimum tax without a significant profit exemption of $100,000 or more would hurt small businesses, already battered by the recession and always in need of capital, the most.

We believe that industrial development bonds and industrial revenue bonds can be useful tools to encourage businesses to come into an area and create jobs, but we also believe that they should be directed to businesses that would otherwise be unable to move into the area and to businesses that would provide the most jobs. In many States, small companies, who would otherwise be unable to afford plant expansion or major equipment purchases, are denied access to the bonds because of regulations pertaining to umbrella bonds. We suspect that restructuring the law in this area could simultaneously make this financing tool more available to small businesses, eliminate past abuses, and perhaps generate some revenues as well. The answer is not to force users of industrial development bonds to a straight line depreciation system, which negates most of their incentive, but to restructure the eligibility requirements so they go to the most appropriate users. One area that might be considered for a tax increase, since it would be evenly distributed among the business community and individuals, is a significant fee on imported oil or a tax on gasoline. This is a large enough tax base that a small percentage could provide many billions in revenue.

It is important that none of us take too narrow a view on the current economic situation. Tax policy can be adjusted not only to bring more Federal revenues necessary under present circumstances, but also to provide additional stimulus for economic recovery. Particular tax measures which can spur increased employment will expand the tax base and aid economic recovery.

Our research has revealed that there are significant numbers of openings for high-paying jobs in our industry at this moment. A census of our membership made in September 1981 and projected for our entire industry revealed a demand for 31,772 skilled workers, even under current economic conditions. These are substantial jobs, jobs which require four years of training and jobs which can easily pay in excess of $30,000 per year. Labor Department data and our contract with other industry groups suggests that there is a direct correlation between the job openings and the level of skill required and the typical size of the business. The higher the level of skill required and the smaller the typical company, the greater the shortage. We believe these shortages exist because the cost of training the highly skilled is very high and because small businesses typically lack the capital necessary to train. Federally funded training programs and incentives, such as the targeted jobs tax credits, have had only limited impact on the problem. This is because the social objective incorporated in the former have restricted access to the types of candidates needed for highly skilled jobs. The same holds true for the latter which is also further limited by the amount of the tax credit. To train someone for a highly-skilled job costs far more than to train someone for a semi-skilled job. For example, the average investment per worker in our industry is $40,000 to $60,000. Productivity is also lost in the training process as our most highly-skilled journeymen take productive time to work side-by-side with apprentices. The targeted jobs tax credit is probably a more than adequate incentive for many job categories but it is not an effective incentive for training the highly skilled because of the costs involved.

At first blush, it might seem that this is a problem only for those few specialized industries requiring highly-skilled workers. It is, in fact, a problem for the entire country. Our industry, the high tech electronics industry, and others like it, are essential to the entire manufacturing community and to our defense industrial base. No major defense system and no major manufacturing endeavor can be carried forward without the skilled labor provided by this industry.

What we fear is that industries like ours, already short of skilled labor, will be unable to satisfy the demands of defense production resulting from the expanded military budget. We also fear that competition for these same skills will result when economic recovery begins in the private sector. With a four-year training period required to produce a journeyman, we are already behind the probable cycle of business recovery.

Senator Orrin Hatch has introduced legislation which would address this problem. His solution is a highly-specialized tax credit limited only to areas where there are significant shortages of highly-skilled labor which are essential to the national defense. The Secretary of Labor and/or the Secretary of Defense would be empowered to certify these skills as essential and in short supply. Only then, and only if there was a significant shortage of the skilled labor, would training of these skills be eligible for the tax credit. This credit would be closely tied to the true cost of training—amounting to 50 percent of first year's wages and 30 percent of second year's wages. There would be no tax credits in the third or fourth years of training because the workers would be making a positive contribution by the end of the second year.

We feel that the critical Industry Reindustrialization Tax Act, S. 1813, is the best interest of the country and is also affordable even under present economic circumstances. It has also been introduced in the House as H.R. 3752. Our preliminary estimates of the revenue impact would be about $300 million the first year using a static economic model. The actual impact would be far less when the feedback effects of a dymanic model were factored in. We are in the process of producing such an econometric model and will be glad to share the results with this committee. If the resulting figures are within a reasonable range, we strongly urge that this legislation become part of this year's tax package.

Thank you.

PHILADELPHIA
NATIONAL
CORPORATION

PHILADELPHIA, PA 19101 • PHONE 215 629-3100

JAMES F LOWERY
EXECUTIVE VICE PRESIDENT
215 629-3869

April 8, 1982

Robert E. Lighthizer, Esquire
Chief Counsel
Committee on Finance - U.S. Senate
Dirksen Senate Office Building - Room 2227
Washington, D.C. 20510

Dear Chief Counsel Lighthizer:

Department of Treasury Explanation
Tax Revisions and Collection Proposals
Released February 26, 1982
Comments re Tax-exempt Revenue Bonds and Corporate Alternative Minimum Tax

As Chief Financial Officer for The Philadelphia National Bank, I would like to take this opportunity to comment on the Tax Revisions and Collection Treasury Explanation and similar plans appearing in the various legislative alternatives currently under consideration.

We support the plan to review the use of tax-exempt bonds for non-governmental purposes and to consider a requirement that such private activities must demonstrate they serve a genuine public purpose. The availability of tax-exempt financing for exempt activities and other private purposes causes distortions in the allocation of scarce capital resources thus raising the cost of financing traditional public projects.

We are, however, quite concerned with the Treasury Department's recommendation to change the minimum tax to an alternative minimum tax and include as a preference item the interest expense incurred to carry state and municipal securities. The alternative minimum tax proposal would either reduce the bank's return on capital or would have to be compensated by governmental borrowers paying higher rates on their securities. Historically, our bank's investment in tax-exempt securities has been motivated by the credit requirements of governmental entities rather than by our conscious effort to reduce our taxes. The proposed alternative minimum tax could make it very difficult and perhaps impossible for state and local governments to borrow at true tax-exempt rates. Commercial banks have played a key role in the transfer of this subsidy to state and local governmental bodies. In a real sense, the interest foregone is a "tax" which is paid to the issuer of the securities rather than the Federal Government. The addition of this "tax" to reflect the taxable bond equivalent dramatically increases the level of taxes paid by commercial banks.

In summary, this proposal raises some difficult questions that I would respectively urge you to consider:

1. How much of the tax increase will be absorbed by banks and how much will be passed through in higher interest rates?
2. What will be the impact of these adjustments on the rate of inflation, the availability of credit and employment?

We appreciate the opportunity to comment on these proposals.

Sincerely,

Statement of
Deloitte Haskins & Sells
Regarding the Administration's Tax Revision Proposals
Submitted to the
Senate Committee on Finance on
April 2, 1982

Deloitte Haskins & Sells is an international public accounting firm with over 330 offices in 70 countries. We provide auditing, accounting, tax and management advisory services to a broad range of individual, business and government clients. These comments are not made on behalf of any specific client, or group of clients, but rather represent our views on five items contained in the Administration's tax proposals released by the Department of the Treasury on February 26, 1982.

We appreciate the opportunity to bring these views before the Committee.

The five items on which we offer comments are:

- The Completed Contract Method of Accounting;
- The Alternative Corporate Minimum Tax;
- Corporate Tax Payment Acceleration;
- Withholding on Dividends and Interest; and
- IRS Enforcement Staffing.

Completed Contract Method of Accounting

We believe that the Administration's proposal to repeal the completed contract and accrual method of accounting for taxpayers with long-term contracts should not be adopted by the Congress. The completed contract method of accounting is often the only method of accounting for long-term contracts that provides a clear reflection of income for tax purposes in those situations where the contract involves a high degree of risk. In other situations the accrual method of accounting clearly reflects income. We must take umbrage with the Administration's contention that the new progress payment method of accounting will provide a better reflection of income than the completed contract method or the accrual method. In our judgment the progress payment method will distort income heavily in favor of the government and as a consequence create tax liabilities for companies without profits.

We share the Administration's view that the percentage of completion method of accounting can best reflect a long-term contractor's income. However, as conceded by the Administration the method has proven to cause severe administrative problems because it requires the taxpayer to estimate the portion of the contract performed and project costs to complete it. As a general rule our tax system abhors the use of estimates and as a practical matter the percentage of completion method is not a realistic alternative for many taxpayers. These problems are not new and as a consequence the completed contract method of accounting was formally brought into our tax system 64 years ago. It allows taxpayers to accurately report income or loss from a contract at the time the contract is completed and all the uncertainties of performance have passed. It avoids the necessity of using estimates and accurately matches contract costs against contract revenues. While it is true that the method allows income to be deferred and therefore postpones the payment of tax, it also defers the recognition of loss until the contract is complete.

Another acceptable alternative has been the accrual method of accounting that defers costs and income recognition until the items are shipped or accepted. This method provides the standards under which taxpayers who regularly produce inventoriable items account for their income and cost of sales.

The alternative proposed by the Administration to these long standing methods of accounting is the progress payment method of accounting. The progress payment method can best be described as inconsistent. First, it is inconsistent within itself because it puts taxpayers on the cash basis for recognizing income while it requires costs to be deferred until income is recognized. Second, it is inconsistent with our income tax system which requires realization of income before a tax is levied. Illustrative of this second point is the feature of the progress payment method that requires loan proceeds secured by a contract to be treated as income.

In summary, the Treasury has admitted the impracticality of the progress payment method but has not provided an acceptable alternative with which to replace the completed contract or accrual methods of accounting.

A second part of the Administration's long-term contract proposal would require certain period costs, heretofore deducted currently, to be deferred as costs associated with a contract. Examples of these costs include interest and general and administrative expenses. In addition to being historically deducted under the completed contract method of accounting, the costs at issue are also deductible by taxpayers who use the mandatory full absorption costing rules for inventory accounting. Therefore, the adoption of the Administration's proposal will create inconsistent treatment between taxpayers who produce items, and stock them for sale, and those who produce unique items under contract.

Without exception, the nature of the costs at issue suggests that they benefit the operation of the business as a whole or are specific statutory incentives which only reach their desired potential if deducted currently. General and administrative expense is an example of a cost that benefits the operations of a business as a whole and the accelerated cost recovery allowance in excess of straight-line depreciation is an example of a provision that provides an incentive to invest which is muted if the deduction is deferred. We believe that the current costing rules for long-term contracts should be retained.

Alternative Corporate Minimum Tax

Congress has enacted a number of tax incentives to encourage economic behavior. By enacting a minimum tax it would be discouraging much of the behavior sought by the incentives. This would be especially true with regard to those businesses that specialize in the favored activities. They would be put at a competitive disadvantage in comparison to taxpayers with higher marginal tax rates, who do not specialize in the encouraged activities. Such a system promotes inefficiencies and penalizes those businesses that have responded to economic needs determined by the Congress. For example, the preference on interest paid to purchase or carry tax-exempt securities will fall heavily on banks, increasing the overall tax burden on the industry by 50-60 percent. Banks as "financial intermediaries" have traditionally responded to tax incentives and have shared the tax benefits in lower prices for particular financing. If a new tax is associated with the municipal market you can expect a further depressed municipal bond market and higher costs of borrowing for state and local governments. This would occur coincident with more of the government financial burden being placed on state and local governments.

Although we conceptually disagree with a minimum tax on corporations, our greatest concern is that its major effect would have nothing to do with the the proposed list of so-called tax preferences targeted by the Administration. This "hidden effect" is caused by the proposed treatment of the investment credit and net operating loss carryovers. Under the proposal, corporations would be required to pay the greater of their regular income tax or an alternative tax equal to 15 percent of their alternative tax base in excess of $50,000. This alternative tax base would consist of regular taxable income, before the net operating loss deduction, plus certain tax preferences. No tax credits other than the foreign tax credit would be allowed against the alternative tax. The excess of the alternative tax over the regular tax would be carried over as a credit against the regular tax.

Not allowing the net operating loss deduction for purposes of the minimum tax would result in companies being subject to the minimum tax even though over a period of years they have had no economic profits and owe no regular tax. Although the minimum tax is carried over and can be used to offset the regular tax once the company continues to be profitable and has used its net operating loss deductions, we see no reason why a business coming from a period of unprofitable years should be required to prepay its regular tax.

Prior to 1979 the investment tax credit was limited to the first $25,000 of tax liability and 50 percent of tax liability in excess of $25,000. In 1978 Congress found this to be an impediment to investment and decided to increase the 50 percent limitation by 10 percent per year until it reached 90 percent in 1982 and thereafter. The unavailability of the investment credit for purposes of the minimum tax reduces this limitation to 67.4 percent. (Since a taxpayer's tax liability before investment credit could be reduced from 46-percent to 15-percent, the investment credit benefit is limited to 31 percentage points therefore 31/46ths or 67.4 percent of the tax is offset by the credit.) This is below the 1980 limitation.

The net operating loss and investment credit rules account for an estimated 60-70 percent of the increased taxes generated from the proposed minimum tax, even though they are not directly treated as tax preferences. This significant change in tax policy as it relates to net operating loss and investment credit utilization will have a significant negative effect on investment decisions and is contrary to the policies adopted through the Economic Recovery Tax Act of 1981. Under the Accelerated Cost Recovery System (ACRS), depreciation deductions are accelerated to provide an investment incentive. These deductions produce lower taxable income or even losses and a resulting lower limitation on the investment credit.

Safe-harbor leasing was made part of ACRS to allow businesses with excess deductions or credits to obtain the benefits of ACRS. The minimum tax proposal applies pressure in the opposite direction by making investment tax credits and net operating losses less valuable. By doing so, it makes leasing more important to any business with low taxable income or a loss. While we beleive that the safe-harbor leasing rules are necessary to allow all companies to share in the benefits of ACRS, we do not believe that added pressure should be put on their use by imposition of a minimum tax. Nor do we believe that the incentives of the Economic Recovery Tax Act of 1981 should be altered by the imposition of a minimum tax with its concomitant effects on investment credits and net operating losses.

Corporate Tax Payment Acceleration

The Administration's Proposal to increase required estimated tax payments from 80 percent to 90 percent of the current year's liability is based on the faulty assumption that corporations have the ability to estimate their income on a monthly basis. As professional accountants we find that the large majority of corporations do not have the ability to estimate taxable income on a monthly basis. To design and implement accounting systems to perform such a task would require a significant cost to business. While the revenue gain from the proposal is transitory the cost to business will continue in perpetuity.

There are also a number of situations in which the best accounting systems cannot provide the needed information because events or transactions that must be taken into account have not occurred. The current law (not being changed by the proposal) requires corporations to make their final estimated tax payment on the 15th day of the last month of the tax year. It will be necessary under the proposal to project the events of the final half-month to properly pay the estimated tax. Although some of these projections can be achieved with sophisticated financial and management reporting systems, for many businesses they are prohibitively expensive and even with their use some transactions will remain unpredictable.

When an underpayment occurs the current 20 percent penalty is extreme. Because the penalty is non-deductible it equates to a 37 percent cost of borrowing for a corporation with a 46 percent marginal tax rate.

Balancing the facts that (1) corporations can not precisely estimate their tax liabilities and (2) there is a government cost to deferred tax payments, it would seem equitable to assess a reasonable interest charge for any underpayment of estimated taxes much the same way interest is charged when a taxpayer is required to pay additional tax because of an audit or the filing of an amended return.

Withholding on Dividends and Interest and IRS Enforcement Staffing

We comment on these two proposals together because in our view they are related. We believe that our tax system should work in a fashion that all taxpayers pay the amount of tax required by law and that increased enforcement activities are appropriate to assess and collect amounts of delinquent tax. However, we also believe that the collection of tax is a government function. If this responsibility is to be shifted to the private sector, as the Administration has proposed with regard to withholding on dividends and interest the burden should be upon the Administration to demonstrate not only that a problem of collecting tax exists, but also that all reasonable government resources have been used and that the burden placed on the private sector is not inordinate in relation to the benefits to be derived.

The Administration has not convinced us (1) that the only recourse for increased compliance is withholding on interest and dividends; nor (2) that the private sector cost is warranted.

We believe that additional resources should be made available to improve the current information reporting system which has already contributed to increased compliance, but in our view has not been used to its full capacity.

* * * * *

U.S. League of Savings Associations
Testimony on the Revenue Measures
Contained in the Administration's FY 1983 Budget

We appreciate this opportunity to comment on the President's revenue increase proposals included in the Administration's fiscal year 1983 budget, as well as other recommendations for improved tax collection and enforcement.* The savings and loan business, Mr. Chairman, is concerned about our nation's prolonged high interest rates which are creating an economic and financial crisis. In order to bring interest rates down, immediate action must be taken to reduce massive federal budget deficits. More than anything else, it is the spectre of an overwhelming volume of deficit financing which haunts housing and financial markets and poses the threat of economic and financial conditions not seen since the 1930s.

Given these circumstances, there is no alternative to: (1) slowing down all spending, not excluding defense and entitlement programs; and, if necessary, (2) deferring previously enacted tax reductions or increasing taxes. Recommending increased taxes does not include supporting a withholding plan whose cost to the private sector far exceeds its expected revenue benefit to the Treasury.

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*The U.S. League of Savings Associations has a membership of 4,100 savings and loan associations representing over 99% of the assets of the $650 billion savings and loan business. League membership includes all types of associations -- Federal and state-chartered, stock and mutual. The principal officers are: Roy Green, Chairman, Jacksonville, FL: Leonard Shane, Vice Chairman, Huntington Beach, CA; Stuart Davis, Legislative Chairman, Beverly Hills, CA: William B. O'Connell, President, Chicago, IL; Arthur Edgeworth, Director, Washington Operations; Glen Troop, Legislative Director; and Phil Gasteyer, Associate Director, Washington Operations. League headquarters are at 111 East Wacker Drive, Chicago, IL 60601. The Washington office is located at 1709 New York Avenue, N.W., Wash., D.C. 20006. Telephone: (202) 637-8900

Even with these actions, the restoration of financial stability and safety will be a slow process. It is necessary, therefore, to adopt immediate but temporary measures to address the critical problems of the industries which finance, market and produce housing for American families. These industries have unfairly borne the brunt of destructively high interest rates. Unless immediate and effective short-run measures are adopted, the continued devastation of these industries will, directly and indirectly, aggravate the federal budget deficit and greatly increase the prospect of a general economic and financial crisis.

Therefore, Mr. Chairman, while we support the President's call for further revenue increases, we disagree strongly on the source of those increases.

Our testimony will: (1) oppose the President's plan to withhold taxes on interest paid to savers at financial institutions; (2) request that the tax loss carryforward provision of last year's Economic Recovery and Tax Act be granted to savings and loan associations; (3) provide a preliminary evaluation of the performance of the All Savers Certificate; (4) propose changing the savings and loan institution's tax law definition; and (5) support with exception the Tax Compliance Improvement Act of 1982.

Withholding

The U.S. League of Savings Associations strongly opposes this Administration's withholding plan because it suffers from a number of important public policy limitations.

First, the proposal does not relieve the Treasury of the responsibility of improving their reporting or audit procedures.

Second, the Treasury's revenue gains from accelerated payments and increased compliance are suspect.

Third, the proposal will impose an additional burden on our savers who, for the most part, are elderly.

Fourth, this proposal threatens the foundation of our tax system based on voluntary compliance.

Finally, but most importantly, the cost of implementing withholding by our institutions will far exceed the Treasury revenue gain.

The U.S. League agrees with the Treasury that illegal or inadvertent tax evasion is indefensible. In support of this position, the savings and loan business, through its 1099 interest reporting program, has made major efforts in assisting the Treasury to improve compliance. Internal Revenue Service estimates, based upon 1976 income, show that 84% of interest income was reported to the IRS that year. Since then, a substantial increase in magnetic tape reporting has occurred among financial institutions which probably raises the 1976 estimate of reportable interest income to over 90%. By perfecting our system of 1099 reporting, the savings and loan business faithfully supplies both the IRS and the depositor with the necessary annual information to pursue those taxpayers who have a tax liability on their interest income. Until this information is fully utilized through matching by the IRS, however, the government shouldn't transfer the burden of interest income tax collection to the financial community.

It is our view that the basic problem of noncompliance will not be solved by withholding nor will it eliminate the burden and expense of current interest reporting. What must be done is to appropriate the funds necessary for the IRS to utilize the tax information already made available to it. In addition, our existing system can be improved by making 1099 reporting universal. To accomplish this, 1099 reporting must be extended to interest payments made to individuals on all securities of a type generally offered to the public, including Treasury and bearer obligations. These changes, along with a more thorough matching system when this information reaches the IRS, will insure greater compliance in the taxation of U.S. interest income.

The U.S. League wants Congress to recognize that this system of Treasury witholding -- calling for use of exemption waivers, annual withholding options, and development of a potentially unfeasible system for withholding on marketable debt securities -- will not achieve the revenue estimates either through acceleration or compliance which are suggested by Treasury.

Indeed, since individuals will be able to make adjustments to avoid interest over-withholding or reduce their estimated tax payments (if they estimate) by the amount of taxes on interest withheld, the Treasury estimate of $1.4 billion in accelerated tax payments for fiscal year 1983 is incorrect. Likewise, the $500,000 figure for increased compliance relies partially upon implementation of a difficult withholding scheme on bearer obligations and other marketable debt securities. If this proves unworkable as many suspect, then the half a million dollars in increased compliance will also be scaled down.

The Treasury claims that consumer harassment will not occur because of withholding. To the contrary, the complex system of exemptions will require notification, explanation, application and exemption updating when a change in status occurs. Let there be no doubt that any withholding system with the necessity of exemptions will be a harassment to savers, particularly our savers who are elderly and, therefore, most involved in the exemption process.

In line with this question of consumer harassment is the important issue of voluntary compliance with our nation's tax laws. A complex and inefficient system of interest withholding will be looked upon by the American people, already overburdened by taxation, as a petty and punitive plan. The question must also be asked, will this proposal cause taxpayers to join the ranks of our nation's underground economy in order to legally or illegally avoid or evade taxes? We believe the benefits of withholding do not justify this risk to our voluntary tax system.

Finally, the operational difficulties and costs of implementing this withholding proposal would be substantial. Four cost elements come immediately to mind. First, there would be the initial setup costs for computer programming and the exemption waiver system; second, the annual maintenance for the withholding system; third, liquidity costs for associations; and, fourth, complications arising from the application of withholding to N.O.W. accounts.

The U.S. League estimates that development of an operational system of withholding and a workable system of exemption waivers and account coding would cost approximately $435 million at our nation's savings and loan associations. Once established, a withholding system involves maintenance and updating. This involves the ongoing costs of withholding on open accounts and the costs for new, closed, or transferred accounts. The cost of these maintenance processes is roughly $325 million "per year" for just our savings and loan associations. In addition, any withheld funds from our institutions transmitted to Treasury obviously will involve a liquidity cost. Assuming a 5% level of withholding, the liquidity replacement cost would exceed $30 million at our associations. Thus, whatever the expected Treasury revenue increase from withholding at our institutions might be, our enormous costs both initially and annually will make this program clearly not cost effective.

With regard to operational difficulties, institutions withholding on N.O.W. accounts will incur numerous problems. The N.O.W. account is highly volatile with balances varying substantially from day to day and week to week. Therefore, customers must maintain sufficient balances in their transaction account to cover withheld funds since Treasury insists that these account balances never fall below an amount equal to the deferred withholding. Unfortunately, it is not known in advance what amount of interest or amount of withholding will occur at the end of an interest payment period, whether it be quarterly or annually. Thus, the financial institution is unable to program its system to insure against insufficient balances and the depositor is unable to do his financial planning because he is unaware of his account balance at the time of withholding. As a result of these anticipated operational difficulties, we will probably increase over-drafts and their related depositor embarassment, non-sufficient funds charges and unnecessary over-draft borrowing costs.

Federal Income Tax Loss Carryforward Period

Under the Economic Recovery Tax Act of 1981, the carryforward period for net operating losses for most businesses was extended to 15 years with respect to losses incurred in taxable years ending after 1975. We believe it is critical that the loss carryforward period for thrifts, now limited to 5 years, be extended to this 15-year period for the following three reasons:

1) To provide an incentive to the troubled merger process for savings and loans and mutual savings banks;
2) To assist in the recovery process for those institutions that survive the current disastrous economic environment; and
3) To give positive assistance to the decision-making process with respect to deferring losses.

The merger process would be greatly benefited by virtue of the fact that losses incurred by acquired thrifts in the early years after acquisition could be effectively utilized against profits occurring at a later time when restructuring takes place. Although purchase accounting provides a needed boost to book earnings in the early years following the acquisition of a troubled thrift, tax losses continue to be generated due to the fact that the pre- or post-merger tax accounting method of the acquired institution will not produce the positive earnings results generated under purchase accounting. Therefore, since net operating losses continue to be generated by the acquired thrift and also possibly the acquiring institution, significant tax loss carryforwards could accumulate, with the write-off expiring after only five years. Thus, by extending the tax loss carryforward period to 15 years, an acquiring institution, faced with its own operating problems over the next several years, could reasonably plan on a future tax benefit from the present losses being incurred.

An institution that is currently experiencing tax and/or book operating losses, has probably exhausted its carryback capacity or is usually considering whether or not to start a restructuring process by disposing of below-market loans or investments using the newly permitted deferred loss accounting method permitted by the FHLBB. However, it may not execute the transaction due to the fact that, for tax purposes, additional losses are created which cannot reasonably be expected to be utilized over the present loss carryforward period. Since tax benefits attached to a tax loss program can offset approximately 30% of the losses recognized, then it is important for one's business judgement to know explicitly what tax benefits are available.

If this loss carryforward period were significantly extended, the financial institution would have more business and operational flexibility because they would receive a needed tax benefit from offsetting their operating tax losses against future income. This additional business flexibility would be most helpful to a troubled savings and loan industry facing our current economic environment.

Performance of the All Savers Certificate

The All Savers certificate was designed to accomplish three primary objectives:

(1) provide a tax incentive for saving;

(2) provide cost-of-funds relief for depository institutions; and

(3) encourage increased home mortgage lending.

The order of priority of these objectives and the degree of the certificate's success depend largely upon one's point of view. Realtors and homebuilders evaluate the success of the certificate in terms of increased home mortgage lending, depository institutions in terms of reducing their cost of funds, and advocates of tax incentives for saving in terms of its ability to induce individuals to save more from current income.

The U.S. League believes it is important to evaluate the actual experience of the All Savers certificate in the context of the environment into which it was introduced and with reference to its performance relative to other savings instruments and not previous savings flow claims.

Since June 1978, four new savings certificates have been authorized for issuance by depository institutions -- the 6-month Money Market certificate (MMC), the 30-month Small Saver certificate (SSC), the 12-month All Savers certificate (ASC), and the 18-month Individual Retirement Account certificate (IRA). Table 1 shows the growth of each of these new certificates over the first few months following their introduction.

TABLE 1

CUMULATIVE BALANCES FOR MMC, SSC, ASC, AND IRA, FIRST FIVE MONTHS, ALL DEPOSITORIES (Billions of Dollars)

Month	MMC[1]	SSC[2]	ASC[3]	IRA*[4]
1	$ 9.1	$ 8.5	$32.6	$ 2.9
2	20.8	13.7	40.0	
3	27.9	17.4	42.9	
4	35.1	26.4	45.4	
5	50.2	40.1		

[1] Beginning June, 1978.
[2] Beginning January, 1980.
[3] Beginning October, 1981.
[4] Beginning January, 1982.

*18-month certificate only.

Source: Federal Reserve Board.

After an extremely warm reception in its opening month, ASC growth has slowed markedly. In spite of this decline, the ASC nevertheless drew the largest deposit inflow in its initial month of any new certificate and remains ahead of the MMC and SSC at the same stage. The MMC and the SSC took about four months to reach balances equivalent to the first month of the ASC. Differences in these growth patterns are, at least to some extent, explained by differences in the economic environment at the time each new certificate was introduced.

The MMC was introduced into a rising interest rate environment; MMC rates rose steadily from 7.45% in June, 1978, when the certificate was first offered, to 9.46% six months later. This rapid and substantial increase in yield followed a period of stable but gently rising rates, so that the MMC became increasingly attractive to savers.

The SSC was introduced in January, 1980, at a fixed rate of 9.0%, relatively low compared to the January, 1980, MMC rate of 11.8%. But interest rates went into a free fall in the spring of 1980, with MMC rates tumbling from 15.7% in March to 7.8% in June. By comparison, then, SSC rates, still at 9.0%, became increasingly attractive.

The ASC was introduced in October, 1981, into a declining interest rate environment following and continuing through a period of highly volatile interest rates. MMC rates had ranged from highs of 16.1% to lows of 11.4% in the preceding 12 months. The opening rate on the ASC was 12.6%, followed by rates of 12.1%, 10.8%, 8.3%, 10.2%, and 10.8%. Although these were after-tax rates of return, savers' perceptions of these yields clearly made the ASC less, not more attractive, given the experience with interest rate volatility in the period just preceding its introduction.

The MMC, ASC, and SSC all have short maturities compared to the IRA. Upon introduction in January, 1982, the 18-month IRA, which carries an unregulated rate of interest, was offered in the 13% to 14% range with either a fixed or a floating rate. These were tax-deferred rates, with the added incentive of tax deferral on the principal balance. They therefore offered after-tax yields substantially above the other three instruments. Yet the initial response to the IRA was weaker than any of the other three.

One may surmise that there are several reasons for the IRA's slow start. It is a very long-term account, with no penalty-free withdrawal before age 59 1/2; only $2,000 per person per year may be deposited; the deposit can be made at any time up to filing one's tax return and still receive full credit for that tax year. Given these characteristics, it is very easy for qualified IRA depositors to defer their decision.

Both the MMC and the SSC were introduced when the economy was relatively strong and interest rate volatility, job insecurity, and a general climate of economic uncertainty were absent. Exactly the opposite has been true for the ASC and the IRA. All three of these factors are at their most intense levels since the end of World War II. Consequently, savers' decisions to place their funds long-term are significantly affected. Even the definition of what constitutes "long-term" has been changed; it is a much shorter time than ever before and when the money market mutual fund alternative is available, savers are much more inclined to keep their funds readily accesible until the economy is again on a stable growth path.

The ASC and the IRA are also relatively complicated savings instruments. The saver's decision to choose either one depends significantly on after-tax yield comparisons. Inasmuch as the IRA has been offered at the equivalent of taxable rates even though the yield is tax-deferred, this factor should not be a problem for the IRA. Roughly speaking, the taxable equivalent return on an IRA at 14% for a taxpayer in the 50% marginal tax bracket is 71.0% per annum. (On a $2,000 IRA deposit, the depositor receives $280 in tax-deferred interest, which is equivalent to $420 taxable interest dollars, and a $1,000 deferral of personal income tax liability.) At such rates of return, after-tax yield comparisons are hardly an issue.

This is not the case with the ASC, which is much less generous with the taxpayer. The tax-exempt yield on the ASC is set at 70% of the yield to maturity on the 52-week Treasury bill. Consequently, the tax-exempt rate on the ASC will always be below the equivalent taxable rate. The depositor's decision to invest in an ASC then must turn on whether or not the tax-exempt ASC rate is greater than the after-tax yield on alternative savings instruments.

Table 2 contains the average after-tax yield comparisons by marginal tax rate (MTR) for each of the seven ASC rates in effect through the first 5 1/2 months of its existence (October, 1981 through March 8, 1982) against its three main alternative savings instruments--MMFs, MMCs, and SSCs. The MMF yield comparisons are based on the composite weekly MMF yield over the entire period following the effective date of the given ASC rate; the MMC and SSC average comparisons are based on the MMC and SSC rates prevailing during the four weeks during which the given ASC rate was in effect. The data in the table are expressed as percentage points. Positive numbers indicate the extent to which the tax-exempt ASC rate exceeds the comparable after-tax yield on the alternative instrument. Negative numbers, of course, indicate the opposite.

TABLE 2

AVERAGE AFTER-TAX YIELD COMPARISONS AT VARIOUS ALL SAVERS' RATES AGAINST ALTERNATIVE SAVINGS INSTRUMENTS
(Percentage Points)

Alternative Instruments by Marginal Tax Rate (MTR)	All Savers Rates						
	12.61%	12.14%	10.77%	8.34%	10.16%	10.76%	10.79%
50% MTR							
MMF	5.83	5.43	4.29	2.06	3.85	4.31	4.05
MMC	5.02	5.13	4.39	2.56	3.78	3.84	3.86
SSC	4.51	4.26	3.78	1.86	3.25	3.44	3.46
40% MTR							
MMF	4.47	4.08	3.00	0.81	2.59	3.02	2.69
MMC	3.50	3.72	3.11	1.40	2.50	2.45	2.47
SSC	2.89	2.68	2.37	0.56	1.87	1.97	1.99
30% MTR							
MMF	3.12	2.74	1.70	0.45	1.32	1.73	1.34
MMC	1.98	2.35	1.84	0.24	1.23	1.06	1.08
SSC	1.27	1.11	0.98	-0.74	0.49	0.51	0.53
25% MTR							
MMF	2.44	2.07	1.05	-1.08	0.69	1.08	0.42
MMC	1.23	1.62	1.20	-0.34	0.59	0.38	0.39
SSC	0.46	0.32	0.27	-1.39	-0.20	-0.22	-0.22
20% MTR							
MMF	1.76	1.39	0.41	-1.71	0.06	0.44	-0.01
MMC	0.20	0.91	0.56	-0.92	-0.05	-0.32	-0.31
SSC	-0.35	-0.47	-0.43	-2.04	-0.37	-0.96	-0.95

To illustrate, a saver who deposited $10,000 in an All Savers certificate at 12.61% has, through March 8, earned annualized after-tax interest income of $176 more in the ASC than in a money market fund if the saver is in the 20% marginal tax bracket, $244 more in the 25% bracket, $312 more in the 30% bracket, $447 more in the 40% bracket, and $583 more in the 50% bracket. Note that these returns are after-tax dollars.

On the basis of after-tax yield, the ASC shows a clear advantage over all of the alternatives at all ASC rates at the 40% and 50% marginal tax rates. This yield advantage also applies at the 30% marginal tax rate, except in December when the ASC rate reached a low of 8.34%. In December, the ASC showed a small yield advantage at the 30% marginal tax rate against the MMC, but not against the MMF or SSC. At the 25% marginal tax rate, the ASC also produced favorable spreads against the MMF and the MMC except at 8.34%. Even at the 20% marginal tax rate the ASC has at times beaten the MMC and MMF yields; only the SSC has consistently produced after-tax yields higher than the ASC at the 20% tax rate.

These yield comparisons strongly suggest the existence of a significant lag in saver recognition of the yield advantages of the tax-exempt All Savers certificate, not a failure of the certificate to produce those yield advantages across a broad spectrum of marginal tax rates. This recognition lag can only be closed by educating the saving public to after-tax yield comparisons. That is a task for marketing.

The ASC marketing effort was intense during September and October, 1981, and a record deposit inflow for a new savings instrument was the result. Marketing emphasis generally switched to the new universal IRA after October, however, on the theory that the IRA account would stay with the financial institution where it was opened. Financial institutions thus took "time out" from marketing the ASC (which expires on December 31, 1982) to attempt to attract and maintain a long-term (IRA) depositor base.

The IRA advertising blitz, coming so closely on the heels of a comparable ASC blitz, undoubtedly resulted in some degree of bewilderment among potential savers. Combined with the uncertainty created by a rapidly deteriorating economy, the consequence has been weaker results for both the IRA and the ASC than would otherwise be indicated by the after-tax yield comparisons.

Savings and Loan Tax Law Definition

Congress approved in March 1980 the Depository Institutions Deregulation and Monetary Control Act (P.L. 96-221). Title IV of that legislation broadens the investment opportunities for federally-chargered savings and loan associations to help them prepare for the eventual deregulation of the savings markets and to enable them to broaden their investment mix to include assets which adjust more readily to inflationary periods. Today, other legislation has been introduced to further broaden savings and loan investment authority in order to make them more viable and competitive financial institutions.

While these changes in the "banking" laws are welcome, they are of limited utility unless corresponding changes are made in the definitional sections of the Internal Revenue Code which apply to "domestic building and loan associations". The current law requires that 82 percent of investments consist of "qualifying real property loans" if S&Ls are to fully utilize their permitted tax treatment. We would ask that list of qualifying investments reflect the changes already in law (P.L. 96-221) and provide for future investment flexibility by lowering the applicable qualifying investment percentage to 72% -- a level, by the way, which currently applies to another type of housing-specialized thrift institution, the mutual savings bank.

Finally, increased taxpayer compliance is an important objective and one the savings and loan business has advocated for years in the form of our 1099 interest reporting program. We support the effort of the Chairman to reverse the increasing compliance problem undermining our tax system. However, a few provisions contained in S. 2198 should be reconsidered. Specifically, the provision, which delays the starting date of interest to be received by all taxpayers suffering net operating losses until their refund claims are filed, will be particularly onerous to savings and loans this year. For example, depending upon the course of interest rates for the balance of this year, it is possible that every association in the country will be operating at a loss for tax purposes for 1982. Also, those savings and loans delaying the filing of their applications for refund (Form 1139) now run the risk of receiving no interest whatsoever from March 12, 1982, to the date of filing of Form 1139 if their claim is not processed by the IRS prior to enactment of S.2198. Thus, at a time when this NOL interest payment is most helpful to those in need, the provision is being changed.

This result is inequitable for the following reasons:
(1) The IRS can deliberately delay the payment of a tax refund for as long as 90 days after Form 1139 is filed, thus causing the "no-interest" provision of S.2198 to become operative.
(2) The preparation of Form 1139 for savings and loans is extremely complex and time consuming due to such issues as the 10-year NOL carryback (available only to financial institutions), consolidated return implications (see below), detailed recomputation of bad debt deductions, etc. Thus, all S&Ls, regardless of

the reason for delay, may be penalized by receiving no interest from the end of the loss year until the refund claim is files. (3) Interest on any tax deficiencies from prior years might be accruing (currently at a 20% rate) even though the deficiency will be completely recovered by an NOL carryback from a subsequent year. Thus, the S&L will suffer a net interest cost until the Form 1139 can be filed unless certain regulations changes are made.

Two other changes need clarification. The first regards IRS authority to impose magnetic tape reporting on persons filing large numbers of returns (S&L institutions). Some of our institutions are still filing paper returns, not because of choice but because of cost. Will exceptions be made for those small institutions who might not be able to absorb even these processing costs in today's economic conditions? Secondly, why impose withholding on depositors who fail to supply the proper social security number when a penalty would accomplish the same objective of increased compliance?

The U.S. League greatly appreciates this opportunity to present its views to the Senate Finance Committee.

Fairmont Industrial and Credit Corporation
Room 309 - Deveny Building
Fairmont, West Virginia 26554
Phone 304 - 363-0442

ROBERT C. BYRD U.S.S.
RECEIVED
MAR 19 1982

March 17, 1982

The Honorable Robert C. Byrd
Room 133
Russell Bldg.
Washington, DC 20510

Dear Senator Byrd:

I am sending to you background material as it relates to the Industrial Revenue Bond activity here in Marion County. I am sure that you will find it most informative and, hopefully, will be useful to both you and your colleagues in enlightening the Treasury as well as those in the current administration intent on eliminating the Industrial Revenue Bond program. As you know, Senator, here in Marion County the whole program of Industrial Revenue Bonds, particularly the processing and the coordinating, has been through the very positive action of our Marion County Commission. The Commissioners have been very positive and supportive and, most importantly, have given close scrutiny to the type of projects that have been presented to them, and they have looked to the Fairmont Industrial and Credit Corporation to review each project for its credibility not only financially but its responsibility as a corporate citizen, and the consideration of the number of jobs that the proposal would generate. It is interesting to note that the current administration continually talks about getting things back on a local level, ridding ourselves of the bureaucracy. Therefore, it is ironic that this program is being challenged for it is probably one of the few programs that is the most cost effective of any economic/industrial development program that we have and, certainly, gives the local municipalities the right to vote yea or nay. It is also important to remember that it is local financing. These dollars are not flowing from Washington. The statements made by the Treasury Department that $6 to $8 billion dollars will be lost revenues if Industrial Revenue Bonds should be continued, has no basis as it is predicated on the assumption that industry would make the investment. I seriously question whether that would really happen given the present interest rates, and, from what we can see, there is very little relief in sight regarding lowering of interest rates which would significantly cause small businesses to have the capacity to borrow.

A Non-Profit Corporation Dedicated to the Development of Industry and Jobs

When the concept of Industrial Revenue Bonds was developed by the Congress it was, as I understand, for small industry and I think, for the most part, that is where the industrial bonds have been used. It is a pity that Mike Wallace, in his 60 Minutes show, did not show the positive results that communities throughout our country have had using Industrial Revenue Bonds. But I won't waste my thoughts and belabor the credibility of Mr. Wallace at this time. In our case here in Marion County, West Virginia, they have not been used by large corporations but by small businessmen who could not afford to expand or to locate a new facility had it not been for the use of the IRBs. In nearly all cases, the money was generated by local financial institutions or a consortium of financial institutions in the region and throughout our great state. These banks are in a sense reinvesting in the community. Just this past month, as you are aware Senator, with the use of IRBs in the amount of $1.57 million from regional and state banks, coupled with a $500,000 West Virginia Economic Development Authority loan, and $230,000 from our organization, the Fairmont Industrial and Credit Corporation, a company was able to purchase the Great Atlantic and Pacific Tea Company Printing facility here in Fairmont. This was very important in that A&P indicated that they would be closing the facility within the month as they were no longer going to be in the business of printing labels. This would have meant a loss of 70 jobs and an annual payroll of $1 million. This payroll, however, was saved and the projections are for 54 additional jobs, and $900,000 additional payroll, by the end of the first year. I might add that, as of today, they have already hired 15 new people. I can tell you, and this can be verified, had we not had IRBs, we could not have made the project go.

I have enclosed for your review a list of the projects that have been developed over the last year with the use of Industrial Revenue Bonds. I need not remind you that this County has suffered the loss of several major manufacturers. Two plants alone caused the loss of $2 million in annual payroll and affected some 500 employees. These old plants were constructed during the early 1900s, as were a lot of other facilities in the northeast. They were large facilities and, as you know, the concept has changed to smaller, energy oriented and cost effective operations. Therefore, the state and local community has been pressed into developing new jobs for the jobless and, again, the IRB program is about the only program we now have to work with since the virtual elimination of the Economic Development Administration and the cut back of SBA and FmHA. The West Virginia Economic Development Authority has only limited funds and these are on a matching basis. The West Virginia congressional delegation has been quite supportive of us through the various federal programs which has had very positive effects. However, it does not appear that we will have that availability in the foreseeable future.

There is always room for improvement in a program as well as compromise. I, therefore, would hope that the Congress review the Industrial Revenue Bond program with the idea of improving rather than destroying and would ask that you give consideration to submitting these thoughts that I have put down to the Congressional Record.

Thank you, again, Senator. I look forward to seeing you on March 28th, in Washington, DC.

Very respectuflly yours,

Norman

Norman J. Repanich
Director

a.

cc: David Brown, President, Fairmont Industrial and Credit Corp.
Hays Webb, Esquire
Mrs. Betty Gill, President, Marion County Commission

Fairmont Industrial and Credit Corporation
Room 309 - Deveny Building
Fairmont, West Virginia 26554
Phone 304 - 363-0442

March 1982

INDUSTRIAL REVENUE BONDS ISSUED

The following are some highlights of recent Industrial Revenue Bonds induced through and approved by the Marion County Commission, Fairmont, West Virginia.

Amount	Jobs	Project
$ 1.9 million	32 New	Red Roof Inn Motel - This area has a 90% occupancy rate and a new motel was needed for the following reasons: ° To house the tourism trade promoted by and given high priority by Governor Rockefeller as a positive industry for West Virginia. ° Because of Fairmont's location in the area, historically business people use Fairmont as a point from which to make their business calls on industrial and commercial clients. This creates a further demand on existing facilities. ° Because of demand brought about by increased activity in the coal and natural gas exploration field.
$ 125,000	30 New	Alco Fence Co. -Manufacturer of chain link fence. Branch manufacture and distribution facility.
$ 340,000	65 Retained	Shop & Save Market - To provide local ownership of a supermarket which would have discontinued operation under out-of-state wholesaler, resulting in loss of 65 to 70 jobs.
$ 400,000	60 Retained 65 New	Country Club Shops - Revitalization of depressed shopping area. Owners have modernized the buildings and stimulated several new business enterprises to locate in the complex, along with a franchised fast food restaurant which was built without IRBs.

A Non-Profit Corporation Dedicated to the Development of Industry and Jobs

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Room 309 - Deveny Building
Fairmont, West Virginia 26554
Phone 304 - 363-0442

INDUSTRIAL REVENUE BONDS ISSUED (cont'd.)

Amount	Jobs	Project
$ 300,000	26 New	Point Spring & Driveshaft (L-R-S Enterprises). Branch of manufacture and distribution of drivetrain equipment and industrial and automotive springs. Total project - $ 550,000 [$ 300,000 IRBs [$ 200,000 W.V. Econ. Dev. Auth. Loa [$ 50,000 Fairmont Inds. and Credit Corp. Loan
$ 1.57 million	67 Retained 54 New	Creative Label Company - Manufacturer of labels for soft drink and pharmaceutical industries. To allow purchase of The Great Atlantic and Pacific Tea Company Printing Plant land, buildings and equipment to continue operations as food label printer and expand to include soft drinks and pharmaceuticals. Total project - $ 2.3 million [$ 1.57 million - IRBs [$ 500,000 W.V. Econ. Dev. Auth. Loan [$ 230,000 Fairmont Inds. and Credit Corp. Loan

UNITED STATES SENATE COMMITTEE ON FINANCE

WRITTEN STATEMENT
OF
GEORGE W. CREGG, C.I.D.
ON
EXEMPT SMALL ISSUE
INDUSTRIAL DEVELOPMENT BONDS
FOR THE
HEARING RECORD OF MARCH 17, 1982

INTRODUCTION

Alexander Hamilton in the New York Packet, Tuesday, January 1, 1788, wrote, "In DISQUISTIONS of every kind, there are certain primary truths, or first principles, upon which all subsequent reasonings must depend".

On another occasion in the Federalist Papers he stated:

> "The individual States should possess an independent and uncontrollable authority to issue their own revenues for the supply of their own wants."

The Federalist system endorsed the doctrine of recprocal immunity. "The powers not delegated to the United States by the Constitution or prohibited by it to the States, are reserved to the States respectively, or to the people" Article The Tenth, Constitution of the United States.

Under the New Federalism of 1982, powers and responsibilities unsurped over the last 50 years of wars and social change should be legally returned to the States.

GENERAL COMMENTS

Hamilton said, "Men, upon too many occasions, do not give their own understandings fair play; but, yielding to some untoward bias, they entangle themselves in words and confound themselves in subtleties".(Emphasis our)

The TREASURY DEPARTMENTS'S GENERAL AND TECHNICAL EXPLANATIONS OF TAX REVISIONS AND IMPROVED COLLECTION AND ENFORCEMENT PROPOSALS contains an abuse of "fairplay" and "untoward bias" that would have shocked Hamilton in spite of his strong preference for a national instead of a federal government.

The section entitled "Tax-Exempt Bonds for Private Activities" is cleverly written in a manner used by many lawyers in writing pleadings and briefs designed to prejudice a court or jury by the use of "labels", "catch phrases", "unfounded conclusions", "spurious assumptions", etc. While I have great respect for the Federal Treasury Department's tax collecting ability, tax policy and economic policy should be made by the Legislative Branch of our Government subject only to the veto of the President. The laws implementing that policy should be interpreted by the Judicial Branch, and enforced by the Executive Branch. Under such circumstances, a report to the Congress such as this document should state unprejudiced facts without the intentional use of emotional and biased words or phrases. The Congressional Budget Office report was fairly entitled "Small Issue Industrial Revenue Bonds" and released April 1, 1981 and prepared under the CBO's mandate to provide nonpartisan analysis with "Policy Alternatives" and "Policy Goals"; not the unfair biased "Proposal Limits" contained in the subject section. The Treasury should have entitled this section "Industrial Development Bonds" and not "Tax-Exempt Bonds for Private Activities". The "public purpose" behind the continuance of the constitutional right of States and their subdivisions to issue Industrial Development Bonds is to encourage the economic development of the whole United States. The exemption from taxation of the interest on such bonds under qualifying circumstances provides not only an incentive for the retention and creation of jobs, but also acts as a strong incentive to modernize the backbone of our small (10 million is small - one U.S. Army tank costs over 2 million) industrial plants, and revitalize our urban areas. The use of the phrase "Private Activities" ignores the "Public Benefit" nature of such financings in bringing about the expansion and development of the economy.

Under the section subtitle "Reasons for Change" (which assumes there are such reasons "for" and none "against"), highlights a growth erroneously preceived as "bad" rather than "good". The growth is good and is a barometer measurement of an improvement in the economic climate. In the second sentence of this subtitle, the "largest growth" is stated to have occurred "in small issue IDB's; implying the "largest" is the "worst". This growth should be no surprise to the Treasury which has successfully blocked the ablility of small business to borrow conventional loans at "reasonable" rates. Treasury obligations issued in great volume in the last few years has skyrocketed interest rates. Reduce federal borrowing and reduce federal spending, let interest rates drop to 6 to 8 percent (7 percent is prevalent in Japan) and small business will return to the conventional market.

The national rate of delinquency on payments on loans from the Farm Home Administration is now at 58%. If you restrict the right of a State agency to issue industrial development bonds, instead of small business expansion you will have small business collapse. Farmers and other who in the past have sought small business jobs in manufacturing during agricultural recessions will have no place to find work. Students graduating and other youths will have no productive future. Welfare expenses and the costs of crime will increase.

The nation's economy is extremely fragile and cannot stand tinkering. Henry Kaufman, well known economist, testified before the House Committee on the Budget on March 16, 1982:

> In closing, I again want to urge you to implement economic policies that will deal effectively with the gravity of the business and financial situation. Patchwork policies will not resolve our problems. Basic reforms in both fiscal and monetary policies are needed. Without them, not only will sustainable economic recovery elude us but greater economic risks may be the consequence." (Emphasis ours)

As Mr. Kaufman pointed our, the credit needs of our Federal Government are now at 28% of the credit market; almost 5 times the demand of the comparable 6% in the 1950's and 1960's. Assuming a current inflation rate of 8%, Mr. Kaufman said "the real rate of return is now about 800 basis points for high-quality corporate bonds -- a postwar record", and indicated that in the 1960's and 1970's "these returns averaged only 275 and 206 basis points, respectively". Mr. Kaufman said, "High 'real interest rates' are dangerous to the seriously weakened financial structures in the private sector..." Some of our big energy companies can still go to the credit market and obtain sufficient money to speculate in huge mergers; money is still available if the risk is small and the borrower is willing to, and can, pay high interest rates. The availability of money is recognized in the last sentence of this subtitle, just before the "Proposal" subtitle with this statement "they are able to raise funds readily in capital markets". The Treasury does not add "at 16%".

The relatively small businesses need tax-exempt rates in order to obtain the money needed to modernize our industrial complex. The fourth sentence in the subtitle "Reasons for Change" indicates the sale of IDB's "affects the market for tax exempt securities as a whole" when the Treasury well knows the real problem is the 28% credit demand of the Federal Government, and not the "minimal affect" of small issue IDB's in the competition for "traditional private corporate capital" which is always expanding. The competion is not with "traditional municipal bonds". In my humble opinion, one month of "all-savers" certificates would have more effect on the municipal credit market than all the small issue IDB's issued to date. Numerous other laws including Glass Steagal, and foreign tax credits have very serious effects on the "traditional municipal" credit market. One unmentioned fact in this subtitle on influencing all interest rates is the unpredictability of Federal monetary policy.

The viability of Industrial Development Bonds is recognized throughout the United States. These Bonds have proven to be the best and most useful tool available for the industrial and any other kind of economic development. If we want to expand and modernize, if we want the kind of capital investment that will compete in todays world markets, we must start by keeping the few incentives that are working. Let the States continue their work unhampered. It is good for our States' economies and for our Nation's economy. It will be good for the economy of the free world. The tax exempt feature of IDB's not only upholds the relationship of State and Federal Governments mandated by our Constitution, it promotes fiscal independence of the States. Local units of government have always been closer to the people and are in the best position to determine their own public policies. States should be allowed to continue to use IDB's to pursue these goals.

The great State of Massachusetts through its Massachusetts Industrial Financing Agency recently completed a study which surveyed 800 of the bay

State's firms that have issued more than 1 billion in IDB's since 1978 and found these bonds contributed greatly to the ability of small companies to expand. The results were certified by a nationally known accounting firm. More than three-quarters of the firms assested had sales of less than $20 million while almost half were under $5 million. 93% of the companies said they would have been forced to alter their investment plans in IDB's were not available. 33 1/3% claimed they would have cancelled their expansion plans; nearly another third said their expansion would have been delayed; 1/5th said their project would have been slashed; and 5% said they would have located in another State. The incentive is to modernize and expand; not locational.

In October of 1981 a similar, study was completed on the "Primary and Secondary Impacts of IDA Financing on the Long Island Economy". The Long Island study concludes, as follows:

> "The Federal government, through IDA financing, can make a major contribution to the growth and viability of the Long Island economy. Based on IDA bonds issued during the 1980-81 period, the Federal government would lose $48,993,250 in interest foregone on IDA bonds issued in Nassau and Suffolk counties. However, the Federal government would gain $396,096,610 in income taxes on direct jobs created and $1,188,221,526 in income taxes on secondary jobs created over a ten-year period. In addition, there would be substantial increases in state income taxes, in state and local sales taxes and in local property taxes".

In the 1976 a study was prepared for the American Industrial Development Council (now the American Economic Development Council, Inc.)

by Dr. John A. Andrews and Dr. Dennis R. Murphy of Emory University entitled "The Interest Tax-Exemption on Industrial Development Bonds: The Cost To The United States Treasury" which reached substantially the same conclusion as the recent Long Island survey. The Emory University study stated as follows:

> "The issuer is not the only party that benefits from the issue of the securities. Since the primary use of the funds is to acquire or improve depreciable property, there will be an economic benefit to the related trades that support the depreciable property in the form of wages, salaries and so on. Beyond this initial stimulus, there is a long term benefit to the immediate area in the from of creation of jobs, resulting in wages, salaries and commissions that in turn create additional activity".

Furthermore the Emory University study concluded:

> "It is clear from the foregoing analysis that previous studies have seriously overstated the net costs to the Treasury because of the tax-exempt interest payable on the IRB's. It is very difficult to argue for the removal of the tax exemption on IRB's on the grounds of the cost to the Treasury in terms of foregone tax revenues."

Dr. Norman B. Ture, in his 1980 study "Economics and Federal Revenues Effects of changes in the Small Issue Industrial Development Bond Provisions" noted that projection of a revenue loss are based on the unrealistic assumption that there are no changes in economic activity in response to a tax change, and concluded that the Federal government would receive a significant revenue gain from increased use of IDB's based upon the increased capital formation with the secondary gains in output, expansion of corporate tax base; and increased individual FICA and income taxes, and corporate payroll taxes. He concluded that increasing the "capital expenditure limit" on IDB's "would generate net gains in tax revenues for the Federal government and for the state and local governments of the issuing jurisdictions."

The New York State Economic Development Council in 1981 undertook its own study of IDB financing in New York State. This study is still under way and is not yet complete. An interim report reviewing replies from 33 of the State of New York's Industrial Development Agencies concluded:

> "The majority of IDA's do not believe the present bond limit is satisfactory but not all agree on what the limit should be. Eight IDA's thought the limit should be $20 million."

ANALYSIS OF TREASURY PROPOSALS

Proposal (1)

There is no need for any such proposal in New York State. The New York State Industrial Development Agency Act clearly defines "public purpose", all meetings of the Agencies are subject to the State's Open Meetings Law", a majority of all the authorized members must act to approve a bond issue, and the members are "appointed by the governing body of the municipality" and shall serve "at the pleasure of the appointing authority". New York's Industrial Development Agencies are well run and adhere to "public purpose" financings. Only 2 small issues have gone into default in over 12 years, and over one and one-quarter billion in financing. The small businesses of New York State have truly been served, and the public purpose of creating and retaining jobs has been fulfilled. Approvals of the elected officials would create serious problems regarding possible individual or municipal liability.

Proposal (2)

New York State's Constitution prohibits gifts or loans to private enterprises. New York would have difficulty with this proposal. On the other hand, New York does allow a long list of tax advantages to industry and business without discriminating as to whether the company involved is seeking tax exempt interest. However, it should be noted that the interest on IDB's is totally tax exempt in New York State with no capital expenditure rule. Most projects are exempt from Sales Tax. The real property is tax exempt though payments are usually made in lieu of taxes. There is no personal property tax in New York State. To require more would be unfair to New York.

Proposal (3)

To require 35 year "extended" life straight line depreciation is obviously proposed to wipe out IDB financing and totally unfair.

Proposal (4)

No change is needed to "help" small businesses in this regard. The Congressional Budget Office report indicates "only 16 percent" of such financings were for Fortune 1000 or 50 companies, and 84 percent were small business.

Proposal (5)

The newest trend in order to react to the lingering recession is to pool resources, and to start up (1) industrial condominums in urban areas and (2) small industrial parks in suburban and rural areas. To do this requires composite letters of credit and guarantees. Proposal 5 discriminates against small business at one of its most recent darkest hour.

Proposal (6)

Registration will increase the cost of issuance, cost of operation of Agencies issuing agencies and result in still higher interest rates. This proposal also discriminates against small business. In New York issues are reasonably and accurately reported to the New York State Department of Commerce even though there is no requirement to do so.

Proposal (7)

The present arbitrage regulations are difficult enough to comply with. The typical New York project has no "reserve fund". However the difficulty of calculating and planning a "zero return" on a temporary construction fund would be impossible. Any such requirement would severely complicate an already expensive procedure and again discriminate against small business in New York State.

Proposal (8)

No comment.

CONCLUSION

America as a nation is dying of "old age". Our infrastructure is decayed. Our bridges, highways and other public facilities are falling apart. Eighty percent of our industrial establishment is operating in 30 to 40 year old buildings. Many of our industrial workers are using World War II machines and tools.

Hiroshima has been largely rebuilt twice since the atomic bomb was dropped. We have been lost in lethargy, cliche attacks on "big business", and rampant regulations and restriction of all business.

As an industrial and economic developer, I know the tools that are useful for modernizing our economy. I am not a theroist.

Industrial Revenue Bonds are under attack because of a mistaken idea that only big-name rich companies benefit at the expense of the taxpayer. The use of a few well known trade names, the listing of a few "abuses" and totalizing volumes of dollars all make for sensational press headlines. However, as responsible representatives of the citizens of our communities, our States and our great Nation, we must examine the true facts in assessing best approach to our rapidly declining position in the World's economy. The economic war between the States is almost over. While a few small areas of our nation are experiencing old fashioned "prosperity", double-digit unemployment is pervading almost every other corner of our great United States, we must act in a very positive way to seek out the causes of our weakening economy. Our close friends in West Germany and Japan have built modern industrial empires. The Communist countries are moving at a relatively slow pace, but they started their "five year programs" of economic expansion from scratch and have been maintaining enormous military budgets. The biggest threat to our economic future is from the middle east. They will be our "friends" as long as we buy their oil, and "subsidize" both their economic development and military budgets.

Richard Henry Lee, author of the resolution of June 7, 1776 calling for independence from Great Britain is known to have said that our great U.S. Constitution was "calculated ultimately to make the states a consolidated government." Patrick Henry supported Lee's belief. The spirit of President Reagan's "New Federalism" is the return of control in fiscal matters to the States.

Alexander Hamilton under the pen name of "PUBLIUS" aptly said:

> "Every thing beyond this must be left to the prudence and firmness of the people; who, as they will hold the scales in their own hands, it is to be hoped, will always take care to preserve the constitutional equilibrium between the general and the State governments. Upon this ground, which is evidently the true one, it will not be difficult to obivate the objections which have been made to an indefinite power of taxation in the United States".

We have faith in our Senators and our Congressmen as representatives of the people and believe that they will follow the great leadership of our founding fathers in upholding the Constitution and in legislating on a fair and unbiased basis.

Industrial Development Bonds are needed now, more than ever, to save our small businesses and to keep our economy from disaster.

(For additional copies of this statement write George W. Cregg, C.I.D., 932 Onondaga Road, Camillus, New York 13031, or Phone 315-468-1479.)

TAX-EXEMPT BONDS FOR PRIVATE ACTIVITIES

General Explanation

Current Law

The interest on State and local bonds issued for private activities is generally taxable, with certain exceptions enumerated in the Code. The exceptions include three general categories of tax-exempt revenue bonds for private purposes: 1) industrial development bonds that qualify as exempt small issues; 2) industrial development bonds issued to finance certain exempt activities; and 3) certain other private purpose revenue bonds. A State or local government obligation is an industrial development bond (IDB) if all or a major portion of its proceeds are to be used in the trade or business of a non-exempt person (that is, a person other than a State or local governmental unit or an organization exempt from tax under section 501(c)(3) of the Code) and the obligation is secured by or is to be repaid from trade or business property or receipts.

Exempt Small Issues: Exempt small issue IDB's can be issued in amounts of $1 million or less for the acquisition, construction or improvement of land or depreciable property located in any one city or county. The $1 million limitation can be increased to $10 million at the election of the governmental issuer provided the aggregate amount of exempt small issues outstanding and capital expenditures (other than those financed with exempt small issues) of the business in the particular jurisdiction do not exceed $10 million over a 6-year period. Current law imposes no restrictions on the type or location of business activities that may be financed with exempt small issues.

Industrial Revenue Bonds For Exempt Activities: Current law also provides an income tax exemption for interest on bonds used to finance certain specific "exempt activities." Some of these bonds are used to provide quasi-public facilities such as airports and mass commuting facilities, but others are used for strictly private purposes such as industrial parks and pollution control facilities. No limitation exists on the amount of these obligations or the locations in which they may be used.

Other Private Purpose Revenue Bonds: Specific statutory exemptions currently allow tax-exempt financing for student loans and for organizations that qualify for tax exemption under section 501(c)(3). The principal section 501(c)(3) organizations that use tax-exempt financing are private non-profit hospitals and private non-profit educational institutions. In addition, mortgage revenue bonds to finance certain owner-occupied housing are eligible for tax-exempt financing through 1983.

Reasons for Change

The volume of tax-exempt bonds issued for non-governmental users has grown rapidly during the past five years. The largest growth has occurred in small issue IDB's, which allow access to tax-exempt financing for any type of trade or business. Continued growth in the use of tax-exempt bonds for private purposes is expected unless actions are taken to limit their use. The expansion of tax-exempt bonds for private purposes affects the market for tax-exempt securities as a whole, raising the cost of State and local governments of financing traditional public services.

Many of the private activities using tax-exempt financing would not have received direct Federal or local government assistance. Access to tax-exempt financing is offered in almost all political jurisdictions, either by State or local governments or by authorities acting on their behalf. These authorities are often established for the sole purpose of issuing tax-exempt revenue bonds for private entities and generally serve as mechanisms for avoiding local voter approval requirements.

Providing tax exemption for the interest on certain private purpose obligations may serve legitimate public purposes in some instances. Current law, however, does not require the showing of any genuine public purpose for the project to be financed with tax-exempt obligations. A requirement that private purpose tax-exempt obligations be shown to serve the needs of the local community would improve the uses of the Federal tax benefit and would limit the volume of such obligations, thus reducing their impact on the market for traditional municipal bonds and on the Federal government's revenue loss.

Tax exemption of interest on bonds issued by State or local governments is an important element of the Federal system of government. However, State and local governments have in many cases become merely conduits through which private parties gain access to the tax-exempt bond market. In addition, some local issuing authorities have profited from their ability to pass on the tax exemption by obtaining fees for authorizing bonds for facilities located outside of their own jurisdictions. Private purpose tax-exempt obligations have also been used to obtain substantial arbitrage profits on reserve funds and funds held during temporary construction periods.

The availability of tax-exempt financing for exempt activities and other private purposes causes distortions in the allocation of scarce capital resources. The ability to obtain a lower cost of borrowing for certain activities, for example, businesses requiring pollution control facilities, through the use of tax-exempt financing creates a bias in favor of investment in those activities. In effect, those favored activities, for example, businesses that create pollution, are subsidized at the expense of other activities. Thus, the allocation of capital investments is based upon government decisions rather than their relative economic productivity. Moreover, in combination with the Accelerated Cost Recovery System (ACRS) provided by the Economic Recovery Tax Act, tax-exempt financing can result in a substantial negative tax or subsidy for qualifying activities. Presently, eligible activities are able to add the tax benefits from IDB's to the tax benefits from ACRS. Permitting tax-exempt financing for private investments that also qualify for ACRS would allow companies to borrow at tax-exempt interest rates for investments that provide generally tax-free income. Those companies could then deduct the tax-exempt interest to shelter income from their other assets.

In contrast with other categories of private purpose tax-exempt bonds, exempt small issues may be used in limited dollar amounts for any type of investment in depreciable property or land. Large businesses presently are able to finance numerous facilities nationwide with small-issue IDB's because the dollar limit applies only to a single city or county. Many large firms are using small issue IDB's even though they are able to raise funds readily in capital markets without a government subsidy or guarantee.

Proposal

The proposal limits tax exemption for private purpose obligations currently eligible under section 103 to those issued under the following conditions:

(1) The highest elected official or legislative body, for example, the mayor or city council, of the governmental unit issuing the bonds and in which the facility is located must approve the bonds after a public hearing. Alternatively, the public approval requirement could be met by a voter referendum on the bonds to be issued for the particular facility.

(2) In the case of bonds issued after December 31, 1985, the governmental unit must make a contribution or commitment to the facility financed with tax-exempt bonds. The contribution could take the form of a cash payment, tax credit or abatement, provision of additional services, or payment of the bond issuance expenses with a value on the date the bonds are issued equal to one percent of the face amount of the bonds. Alternatively, the issuing governmental

unit can satisfy the commitment requirement by insuring or guaranteeing the bonds or by designating the bonds as general obligations of the State or local government.

(3) The costs of depreciable assets financed with tax-exempt bonds must be recovered using straight-line depreciation over the extended recovery period used for earnings and profits computation purposes.

(4) Exempt small issue IDB's will be limited to small businesses. A small business is defined as a business that has capital expenditures of less than $20 million over a six-year period. In addition, bonds would not qualify as exempt small issue IDB's if the business will have more than $10 million of IDB's outstanding after issuance of the bonds.

(5) With these restrictions, small issue IDB's could be sold as a part of a composite or umbrella issue of bonds.

(6) Each bond must be in registered form and information concerning the issuance of the obligations must be reported by the State or local government to the Internal Revenue Service.

(7) Restrictions on the investment yield from the use of the proceeds of the obligations are extended to reserve funds and funds held during the temporary construction period. Bond costs may not be taken into account in determining the yield for purposes of the arbitrage limitations.

(8) Except as indicated above with respect to the financial contribution or commitment requirement, the additional restrictions generally apply to private purpose bonds issued after December 31, 1982. However, the restrictions will not apply to single-family mortgage subsidy bonds issued before January 1, 1984, since such bonds after 1983 will be denied tax-exempt status.

Effects of Proposal

The proposal will impose needed limitations on access to the tax-exempt market for private activities. The volume of tax-exempt financing for private purposes has grown enormously during the past five years. New issues of private purpose tax-exempt bonds rose from $8.5 billion in 1976 to over $25 billion in 1981, as shown in the following table. The dollar volume of private purpose bonds increased at an annual rate of 25 percent between 1976 and 1981, while public purpose bond volume rose at a 1 percent annual rate during the same period. Private purpose bonds accounted for 48 percent of the tax-exempt bond market in 1981 compared with only 24 percent in 1976.

Growth in Private Purpose Tax-Exempt Financing
1976 to 1981

	Volume of Tax-Exempt New Issues ($ billions)		Annual Rate of Growth Between 1976 & 1981 (In Percent)
	1976	1981	
Housing	$3.0	$6.9	18%
Private Hospitals	1.9	3.5	13
Student Loans	0.1	1.0	58
Pollution Control	2.1	3.8	13
Small Issue IDB's	1.4	10.5	50
Total	8.5	25.7	25

The reduction in private purpose tax-exempt bonds will help restore the benefit of tax-exempt financing for traditional governmental purposes and will reduce the growing Federal revenue loss attributable to the increasing volume of private purpose tax-exempt obligations. The benefit from tax-exempt financing to borrowers has traditionally been a savings of 30-35 percent of the taxable interest rate. The benefit from tax-exempt financing has fallen to 15-20 percent of the taxable rate on 20-year obligations in 1981, due in large part to the high volume of private purpose tax-exempt bonds. Lowering the volume of private purpose tax-exempt bonds will reduce the interest rates necessary to attract funds to the tax-exempt market.

The proposal requires business users to choose between the benefits of tax-exempt financing and the tax savings from accelerated depreciation allowances. The result is to make the after-tax cost of capital for businesses using ACRS without tax-exempt financing nearly equal to the cost for those using IDB financing. For example, a firm choosing to finance a plant with IDB's after the proposal will have tax benefits equal to 23-29 percent of each dollar invested compared with 26 percent without IDB's. Similarly, for firms financing equipment (5-year ACRS recovery property), the tax savings per dollar invested will be 48-54 percent with IDB's after the proposal compared with 49 percent without IDB's. Without the proposal the combination of tax-exempt financing, ACRS, and the investment tax credit for equipment results in tax savings of 61-67 percent per dollar invested, which offsets not only the future income tax attributable to the equipment, but also the tax on income from other investments.

These restrictions on the use of tax-exempt bonds by private entities are consistent with the goals of the Economic Recovery Tax Act. ACRS provides tax incentives similar to tax-exempt financing, but does so for all capital investments, not just a select group. ACRS is, therefore, an appropriate substitute for tax-exempt financing.

Subject to the additional restrictions on IDB's generally and small issue IDB's in particular, small issue IDB's would be allowed to be sold as a part of a composite or umbrella issue of bonds. When these bonds are limited to small companies, it is appropriate to permit the marketing of packages of these issues to reduce transaction costs and to provide a degree of diversification that may decrease the risk premiums demanded by investors.

Revenue Estimate

Fiscal Years					
1982	1983	1984	1985	1986	1987
($ billions)					
--	-0.2	0.3	1.1	2.1	3.2

TAX-EXEMPT BONDS FOR PRIVATE ACTIVITIES

Technical Explanation

Summary of the Proposal

To insure that tax-exempt obligations issued for private activities serve valid public purposes, the obligations must be approved, after a public hearing by the highest elected official or legislative body of the jurisdiction in which the project is to be located or by a voter referendum.

For bonds issued after December 31, 1985, the governmental unit must make a financial contribution or commitment to the project. The contribution may be a direct grant, tax abatement, or provision of additional services having a value of at least one percent of the face amount of the bonds. The financial commitment may take the form of a general obligation of the governmental unit, or primary guarantee or insurance of the bonds.

Depreciable assets financed with tax-exempt bonds must be written off using the straight-line method over the extended cost recovery period used for computing earnings and profits.

Small issue IDB's will be limited to small businesses that have no more than $20 million of capital expenditures during a six-year period and have no more than $10 million of industrial development bonds outstanding immediately after the issue.

The bonds must be in registered form and information must be reported to the Internal Revenue Service upon the issuance of the bonds.

Restrictions will be placed on the ability of issuers to earn arbitrage profits.

Except as otherwise indicated above, the additional requirements generally would apply to bonds issued after December 31, 1982.

Detailed Description

The proposal imposes four additional requirements on State and local governments issuing tax-exempt bonds for private purposes. Private purpose tax-exempt bonds subject to these requirements include industrial development bonds (section 103(b)(2)); qualified scholarship funding bonds (section 103(a)(2)); and bonds issued for use in a trade or business by section 501(c)(3) organizations (section 103(b)(3)(B)). A fifth requirement prohibiting "double dipping" of tax benefits will apply to all industrial development bonds. A sixth requirement limits small-issue IDB's to small businesses. Mortgage subsidy bonds (section 103A) issued before January 1, 1984 (the "sunset" date for such bonds), are not subject to these requirements.

The first additional requirement is that the bond issue must be approved by the highest elected official or legislative body of the governmental unit by or on whose behalf the bonds are issued and in which the project financed by the bonds is to be located (or in which the eligible sellers of student loan notes are located, in the case of qualified scholarship funding bonds). To satisfy this requirement, bonds issued by or on behalf of a state could be approved by the governor or the State legislature; and bonds issued by or on behalf of a city could be approved by the mayor or the elected city council. As an alternative, the public approval requirement could be met by a voter referendum on the bonds to be issued for the particular project. Any bonds issued by or on behalf of more than one governmental unit must be approved by each governmental unit involved. The public approval requirement would be an additional requirement of the Federal tax law and would not affect the procedures used to approve bonds under applicable local law.

Prior to approval of a bond issue, a public hearing must be held to give members of the public the opportunity to comment upon the proposed bond issuance. Notice of the public hearing must be given prior to the date the public hearing is held. Similarly, notice must be given to the public promptly after the approval of the bonds. Generally, the notice would be sufficient if given in the same manner as required for other legal purposes, for example, by advertising in local newspapers. Both the notice of the public hearing and the notice of approval of the bond issue must describe the facility or activity to be financed by the bond issue and must specifically state the public purpose or purposes that will be served.

The second additional requirement is that the governmental unit issuing the bonds must make a financial contribution or commitment to the project. This requirement will apply to bonds issued after December 31, 1985. A contribution to the facility or project must have a present value equal to one percent of the face amount of the bond. The contribution can take the form of a cash payment, tax credit or abatement, provision of additional services, or payment of bond issuance expenses. The present value of scheduled future contributions to the facility or project must be determined by discounting the future contributions by the yield on the bonds. The contribution must be specifically earmarked for the facility or project and must be approved by the elected official or legislative body that approves the bond issue. General tax reductions or regular services provided to all facilities are not counted for this purpose. However, general tax exemptions provided for exempt organizations under State law could be used to satisfy the contribution requirement with respect to projects for exempt organizations. The governmental unit may not be reimbursed by the user of the facility for any contribution used to satisfy this requirement.

As an alternative means of satisfying the second additional requirement, the issuing governmental unit can make a financial commitment to the project in either of two ways. The financial commitment requirement could be satisfied if the bonds issued are general obligation bonds of the State or local government, or if the State or local government assumes responsibility as the primary insurer or guarantor of the bonds.

The third additional requirement is that the bonds must be in registered form and the issuance of the obligations must be reported by the State or local government to the Internal Revenue Service.

The fourth requirement is related to the unlimited yields issuers presently can earn on private purpose tax-exempt bond proceeds during the temporary construction period and on reserve funds (section 103(c)(4)). The proposal eliminates the exceptions for the temporary construction period and reserve funds for determining whether the bonds are arbitrage bonds. The yield calculation for arbitrage limitation purposes cannot take bond issuance costs into account.

A limitation applying to all industrial development bonds (section 103(b)(2)) is that the costs of depreciable assets financed with tax-exempt IDB's must be recovered using the straight-line method over extended earnings and profit recovery periods (section 312(k), as amended by Section 206 of the Economic Recovery Tax Act of 1981). Assets will not qualify for treatment under the Accelerated Cost Recovery System (ACRS) if they are subject to IDB financing when placed in service by the taxpayer even though the IDB financing was originally obtained by another person or is subsequently paid off. Assets qualifying for the investment tax credit under present law (section 38) will remain eligible for the credit even though they are financed with tax-exempt bonds. The depreciation allowance for any asset financed with tax-exempt IDB's shall be the amount determined under the straight-line method (using a half-year convention in the case of property other than the 15-year real property, and without regard to salvage value), using the following recovery periods:

ACRS Classification	Straight-Line Recovery Period if IDB Financed
3-year property	5 years
5-year property	12 years
10-year property	25 years
15-year real property	35 years
15-year public utility property	35 years

For depreciable assets that are not completely financed with IDB's the denial of ACRS will apply only to the portion financed with tax-exempt debt. Special rules will be provided for determining which assets are deemed to be financed with IDB's.

The final limitation on private purpose tax-exempt bonds restricts the use of small issue IDB's (section 103(b)(6)) to small businesses, defined as those with capital expenditures of less than $20 million during the period from three years before through three years after the issuance of the bonds. In addition, bonds will not qualify as exempt small issue IDB's if the business would have more than $10 million of industrial development bonds outstanding immediately after the sale of the bonds (excluding any previously issued bonds redeemed with the proceeds of the bonds in question). The $1 million and $10 million limitations of existing law will continue to be applicable, except that bonds will not be disqualified solely because they are sold as a part of a composite or umbrella issue of bonds.

Effective Date

Except as otherwise noted with respect to the financial contribution or commitment requirement, these provisions will apply to all private purpose bonds issued after December 31, 1982, including refunding bonds. However, the provisions will not apply to single-family mortgage subsidy bonds issued before January 1, 1984, since such bonds after 1983 will be denied tax-exempt status.

STATEMENT
OF THE
AMERICAN GAS ASSOCIATION
BEFORE THE
SENATE COMMITTEE ON FINANCE
ON THE
ADMINISTRATION'S PROPOSED TAX REVISIONS

April 2, 1982

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Introduction

The American Gas Association (A.G.A.) is a national trade association comprised of nearly 300 natural gas transmission and distribution companies serving approximately 160,000,000 consumers in all 50 states. A.G.A. member companies account for approximately 85% of the annual natural gas utility sales in our nation.

The Administration's proposed tax revisions and the reduction of investment capital which would result therefrom are of particular interest to A.G.A. member companies because the cumulative capital investment of the natural gas utility industry is projected to rise to the level of $482 billion (1982 dollars) between 1982 and 2000. This figure is an estimate of the amount of capital required by the gas industry to finance the high end of the "North American Focus" supply scenario.*/ In addition to being an estimate of the funds needed to finance supply development, the $482 billion figure includes the amount of capital required to meet pipeline and distribution system maintenance and construction.

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*/ The "North American Focus" supply scenario projects a range of natural gas supply from 26.0 to 32.0 Tcf in the year 2000.

In order to develop fully our nation's domestic natural resources and to reduce our dependence on foreign oil, a continued high level of investment is required in natural gas exploration and development projects. To attain this high level of investment and to achieve the above-outlined capital requirements, A.G.A. believes that current tax policy, designed to foster plant modernization and investment in productive assets and projects, must remain intact in order to provide the certainty, predictability and reliability necessary to maintain both industry and investor confidence.

While A.G.A. recognizes the current pressure on the Administration and Congress to reduce the mounting budget deficit, it does not believe that a retrenchment in investment incentive tax policy is the correct means to reduce the budget deficit. For A.G.A. member companies in particular, imposition of a corporate minimum tax in the form proposed by the Administration would work to undermine the value of the major business investment incentives enacted over the past decade, including those created in the Economic Recovery Tax Act of 1981 (ERTA).

It should be noted that the primary benefits granted to utilities in ERTA under the accelerated cost recovery system (ACRS) are not as generous as they are for other industries. In the ACRS, long-lived public utility property is relegated to a recovery period of either 10 or 15 years while the long-lived property of most other industries is placed in a 5 year recovery period. The Economic Report of the

President transmitted to the Congress in February of this year shows at page 124 that the effective tax rate for utilities prior to ACRS was 43.2%, whereas after ACRS it is estimated to be 30.6%. This is an effective rate benefit of just over 12%. In contrast, the mining industry had its effective rate lowered by 31.8% (28.4% to -3.4%), primary metals by 26.5% (34.0% to 7.5%), motor vehicles by 37.1% (25.8% to -11.3%), and paper by 27.6% (28.5% to 0.9%). Other industries also received a comparable significant lowering of their effective rates.

Corporate Minimum Tax Proposal

As the previously cited Economic Report of the President demonstrates, the utility industry has been a substantial tax paying sector for many years with natural gas utilities contributing their fair share of these tax revenues. For many A.G.A. member companies, however, the corporate minimum tax proposal as currently drafted would result in a significantly higher tax liability in 1983 and subsequent years and, thereby, would substantially reduce what is already a comparatively small benefit received from ACRS. Such a tax would effectively undercut current investment incentives, jeopardize future capital investment projects and penalize companies which have relied on current investment incentives. Specifically, many A.G.A. member companies, in making long-term capital investment decisions, relied on their ability to use the investment incentives in the current law, including the investment tax credit (ITC).

Enactment of the current corporate minimum tax proposal would increase the tax burden on the natural gas utility industry and, in effect, would take away the investment incentives that had been relied on to help finance needed capital projects. The corporate minimum tax, therefore, would require companies to obtain alternative financing and would essentially penalize them for relying on both long-standing and newly-created investment incentives.

Specifically, A.G.A. member company-sponsored projects which have relied on current investment incentives and which would be penalized under the current minimum tax proposal include (but are not limited to) the Alaskan Natural Gas Transportation System project and the Great Plains Coal Gasification project.

Moreover, while the corporate minimum tax proposal does not identify the ITC as a tax preference item, the mechanics of the proposal, in effect, operate to convert the ITC into the most substantial of all the preference items. This occurs because the present law permits the ITC to offset up to 90% of tax liability and, any company which fully uses the credit up to this 90% limit would invariably be required to pay the corporate minimum tax because that tax would always be greater than the regular tax after the 90% offset. This results even though the company may never have used any of the tax preference items which the proposal specifically identifies.

In summary, A.G.A. believes that for the regulated gas industry, the Administration's proposed corporate minimum tax would undermine much of the investment and modernization incentive inherent in the tax laws. Under present law, the business community as a whole, and the regulated natural gas utility industry in particular, were encouraged by what appeared to be a national tax policy designed to stimulate investment in productive assets. This investment climate, which is conducive to economic recovery, should not be jeopardized by imposing a counter-productive corporate minimum tax.

Business Energy Credits

A.G.A. believes that repeal of the business energy investment credits as proposed by the Administration would also undermine the energy investment planning and strategy of A.G.A. member companies which have relied on the existence of these business energy credits. At the very least, companies which have made more than de minimis planning and development commitments (such as feasibility, engineering and environmental studies) should be permitted to retain the business energy investment credits otherwise available to them under current law.

Acceleration of Corporate Tax Payments

A.G.A. believes that, for the regulated gas utility industry, the proposal to accelerate estimated corporate income tax payments to 90% is unreasonable. Such a requirement is particularly unwarranted for an industry whose monthly revenues and income depend largely on the weather. The day-to-day changes in the weather and temperature can result in substantial and unpredictable fluctuations in utility income. In light of this inability to project income accurately, A.G.A. recommends that no penalty provision be included in any proposal to accelerate estimated corporate income tax payments. Rather, any such proposal should include a simple deductible interest charge in lieu of a penalty for an unintentional understatement of income.

Tax-Exempt Bonds

A.G.A. believes that utilities should be exempt from the Administration's proposal to require depreciation of assets, financed with tax-exempt bonds issued after 1982, using the straight-line method over the extended recovery period used for earnings and profits computation purposes. A purpose of this provision arises from a concern over the loss of revenue that would result, in certain circumstances, when ACRS is combined with tax-exempt financing.

In order for utility property to be eligible for ACRS under ERTA, all benefits of ACRS must be normalized in setting rates charged by utilities to customers and in reflecting operating results in regulated books of account. We believe that normalization of ACRS, which is applicable only to utilities, will avoid the revenue loss presumed to be caused by utility use of tax-exempt bonds. Therefore, although we share the concerns the proposal addresses, we do not believe a blanket rule against use of ACRS with tax-exempt financing should be exacted. Rather, utilities normalizing ACRS should be exempt from the proposal since normalization averts the revenue loss which the proposal attempts to control.

Modification of Current Proposals

If a corporate minimum tax proposal is to be a vehicle to relieve budget deficit pressures, then A.G.A. would recommend the following:

- Any corporate minimum tax proposal should include a provision which permits at least a 50% use limitation on the investment tax credit with the same carry back and carry forward period as exists under current law. Otherwise, investment tax credits would go unused because the proposed minimum tax credit carry forward is ineffective in preserving these investment credit incentives in the event a company found itself in a minimum tax liability posture for a protracted number of years.

- A corporate minimum tax proposal should greatly reduce the amount of intangible drilling costs (IDC) considered a tax preference so as not to frustrate exploration and development of our domestic natural gas resources. The minimum tax could provide a net income offset such as that available to individuals.

- In determining the amount of excess IDC in any year for individuals, the IDC incurred in that year is generally reduced by a ten-year amortization factor, but not until the year in which the production has commenced. The Administration proposal also allows a ten-year amortization offset, but there is some question whether this offset can be applied against the IDC of all properties, or must be applied on a property-by-property or well-by-well basis. For example, if a corporation incurs $5 million of IDC on a well in 1983 and is still drilling that well in 1984, there would be no amortization offset allowed for 1983. Thus, the full $5 million of IDC would be a 1983 tax preference item. If the well is completed and begins production on September 1, 1984, after incurring additional IDC in 1984 of $2 million, then 4/120 or 3.3 percent of the $2 million (rather than $7 million) would seemingly be allowed as an offset against the IDC added to the minimum tax base for 1984. Although amortization is presumably allowed against IDC incurred for that well in subsequent years, IDC incurred after a well starts producing is generally minimal. Thus, there will apparently be no amortization of IDC in a later year.

- If IDC is to become a tax preference item, it should be provided that the unused 120-month amortization offset of the total IDC incurred (i.e., $7 million) can be utilized as an offset against IDC incurred in drilling other wells. If such treatment is denied to the taxpayer, then the benefit of the amortization offset is without substance, since: 1) there will be little, if any, IDC after production has started; and, 2) there will be no IDC offset where substantially reduced production causes a well to be abandoned in a subsequent year, before the costs attributable to that well have been recovered.

Conclusion

A.G.A. believes that the corporate minimum tax proposal as currently drafted would undermine investor confidence and industry reliance on both long-standing and newly-created investment incentives. A.G.A. offers its resources and facilities to assist in forging a workable solution to the difficult budgetary questions facing Congress, the Administration and our nation.

STATEMENT OF
THE INTERNATIONAL COUNCIL OF SHOPPING CENTERS
ON THE
ADMINISTRATION'S TAX PROPOSALS

PRESENTED BY

WALLACE R. WOODBURY

SUMMARY OF STATEMENT

The members of the International Council of Shopping Centers (ICSC) believe that the current economic downturn requires the adoption of tax and economic policies which encourage and promote investment. The need for such policies is particularly acute in the real estate industry. The ICSC, therefore, urges that the proposal to restrict industrial revenue bond financing and the proposal to expand the limitations upon the deductibility of construction period interest and taxes be rejected and the current limitations upon the deductibility of construction period interest and taxes be repealed.

The ICSC maintains that IRB financing causes little, if any, net federal revenue loss while generating substantial federal, state and local income, sales and real estate taxes through the development, construction and operations of retail sales facilities.

Construction period interest is a legitimate business cash outlay and should be treated like other expenses of business. It is discriminatory to single out construction period expenses by denying deductions which are accorded all other business expenses.

In addition, the ICSC suggests that the repeal of energy tax credits at this time will cause increased energy consumption and, consequently, greater dependence on foreign energy sources.

The country has made significant progress in the last two years in reducing dependence on foreign oil, but such progress will be slowed or curtailed by repeal of the credits.

STATEMENT OF
THE INTERNATIONAL COUNCIL OF SHOPPING CENTERS
ON THE
ADMINISTRATION'S TAX PROPOSAL
TO
THE COMMITTEE ON FINANCE
OF THE
UNITED STATES SENATE

APRIL 2, 1982

I. INTRODUCTION

I am Wallace R. Woodbury of Woodbury Corporation, Salt Lake City, Utah. I am a member of the Tax Subcommittee of the Government Affairs Committee of the International Council of Shopping Centers.

ICSC is a business association of approximately 10,000 members. These members are shopping center developers, owners, operators, tenants, lenders and others engaged in related business enterprises. ICSC represents a majority of the 22,000 shopping centers in the United States.

It is estimated that more than 5.9 million people are regularly employed in shopping centers and that several hundred thousand more are annually engaged in new construction. The rippling effect of shopping center development on employment in related businesses, including display advertising, maintenance and cleaning, legal and accounting, and the production and transportation of goods sold in the centers, is considerable.

II. ECONOMIC BENEFITS OF SHOPPING CENTER DEVELOPMENT

The extent of the contribution of shopping center development to the nation's productivity is not fully understood. Many people think of productivity solely in terms of the process leading directly to the manufacture of goods. Others would broaden the concept to include the distribution of those goods to the loading docks of the nation's retail facilities--but not to the distribution of products to the ultimate consumer. The fact is, of course, that retail facilities, as the final link in the chain of distribution, are an integral part of the productive process. Thus, to deny tax benefits to retailers but provide them to manufacturers or distributors is self-defeating and inconsistent since, without retail facilities, there can be no expansion of other links in the economic and production chain.

A. Employment. Shopping centers generate new jobs and secure existing jobs in a number of ways which represent tangible benefits to the community. Of course, the construction of a center provides employment to all sectors of the building trades. In addition, the ICSC has estimated that the tenants of shopping centers employ one full-time employee for every 400 to 500 square feet of gross leasable area space. Thus, a typical neighborhood or community shopping center of 175,000 square feet anchored by a soft goods store and a supermarket employs between 350 and 435 people. Moreover, many of these people, as recent entrants into the job market, would have been unemployable or marginally employable in industrial positions.

The increase in employment generated by shopping center development ripples through the local community as other businesses open or expand to provide the services for the new employees. Each new opening or expansion creates, in turn, new jobs and additional revenues.

B. Tax Revenues. It is difficult to dismiss the economic impact of shopping center development in local communities when one looks beyond abstract projections of sales and property tax revenues and considers the empirical data on the actual performance of shopping centers. Sales taxes and real property taxes are two of the largest sources of state and local revenue attributable to shopping centers. Other direct contributions to local treasuries include business license revenues and personal property taxes on such things as office and retail equipment and inventories.

For example, a 1975 study published by ICSC included a twelve-year case history of the fiscal impact of a large shopping center in Oak Brook, Illinois. The Oakbrook Regional Shopping Center is no more typical of the diverse facilities developed by ICSC members than any one shopping center can be. Nevertheless, the Oakbrook study suggests generally the powerful fiscal influence shopping centers can exert.

During the period from 1963 through 1973, the Oakbrook shopping center was the primary source of sales tax revenue for the Village of Oak Brook, Illinois. The shopping center's share of total municipal revenues ranged from a high of 91.3 percent in 1965 to 75.4 percent in 1973 (the last year for which the study developed data). Even after taking into account the very modest increase in municipal tax expenditures attributable to the shopping center's presence in Oak Brook (for example, increased police and fire protection and local road maintenance), the ICSC study found that in 1973 Oak Brook received net cash-flow benefits in excess of $1.2 million directly attributable to the shopping center.

Without this net revenue source, the report concludes that Oak Brook would have experienced a deficit requiring either a decrease in expenditures or another income source. In fact, the local tax revenue generated by the shopping center allowed Oak Brook to maintain services without imposing a property tax for a number of years.[1]

III. CONSTRUCTION PERIOD INTEREST AND TAXES--IRC SECTION 189

Section 189 of the Internal Revenue Code, enacted by the Tax Reform Act of 1976, requires that a taxpayer other than a corporation (which is not a subchapter S corporation or a personal holding company) capitalize real property construction period interest and taxes. The amount capitalized may be amortized over a 10-year amortization period which was phased in and becomes fully effective as to commercial and industrial property in 1982 and as to residential property in 1984. Thus, although this provision has already had an adverse effect upon the real estate industry, the full impact of the provision has not yet been fully felt.

A. Capital Formation. The current law has the effect of draining capital from the real estate industry since interest and taxes are real, out-of-pocket expenses which have to be paid whenever due. By forcing individuals who develop real estate to capitalize these actual business expenses rather than allowing them to deduct them currently as others are allowed to do, section 189 diminishes the capital available for the development of real estate.

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[1] Levin, Measuring the Fiscal Impact of a Shopping Center on its Community, page 30; International Council of Shopping Centers, 1975.

In addition, Section 189 is highly inflationary because, by increasing the capital required it increases the cost of development, and those who wish to construct a property must either abort the project or recover this increased cost of development through higher rents to lessees and higher prices to purchasers. In addition, businesses who lease, or who construct their own facilities, will pass these costs on to consumers through higher prices.

B. Equity. Section 189 is especially harmful to new and/or not-so-wealthy entrepreneurs, who do not have large amounts of capital and who must raise additional capital as a result of this provision. This burden is especially onerous at current high interest rates. Consequently, these entrepreneurs are discouraged or prevented from entering into otherwise viable housing and other real estate developments or constructing new or expanded facilities for their businesses. Thus, Section 189 discourages competition and increases prices.

Repeal of section 189 will merely allow a dollar-for-dollar deduction of amounts actually paid as interest and taxes during the construction period, which is the time when capital is most needed, and will equalize the treatment of interest and taxes, which are actual out-of-pocket expenses, between real property business expenses and all other business expenses, none of which is subject to this onerous provision. The tax code currently treats the income from real property investments as business income, and it is inequitable to deny expense treatment to the costs which generate that income.

C. Recommendations. The administration has proposed extending this investment disincentive to all corporate taxpayers. In light of the adverse consequences which section 189 now has on most real estate development, we support the repeal of section 189 retroactive to its original effective date. Repeal of section 189 will equalize the treatment of interest and taxes, which are actual out-of-pocket business expenses, between the real estate industry and other business endeavors. Repeal also would remove the discrimination created by imposing this section against individuals and not against corporations which construct real property. Most importantly, repeal will encourage investment in productive real property, encourage expansion of current retail and manufacturing plant, and reduce rents.

IV. BUSINESS ENERGY PROPERTY INVESTMENT TAX CREDITS

Section 46 of the Internal Revenue Code, enacted by the Energy Tax Act of 1978 and modified by the Crude Oil Windfall Profits Tax Act of 1980, provides additional tax credits for investment in conventional and unconventional classes of energy property. The credits for conventional energy conservation technologies are scheduled to expire on December 31, 1982, and the credits for unconventional energy conservation technologies are scheduled to expire on December 31, 1985.

A. Specially Defined Energy Property. Although the business community has made significant progress in recent years to reduce energy consumption, energy conservation remains a major and essential national priority. The need for incentives is clearly related to the continued price controls imposed upon natural gas. However, even the decontrol of all energy sources would not eliminate the importance of investment incentives for energy conservation property. Such incentives merely correct the investment disincentives which have become imbedded in the economy through past price and allocation control as well as unfavorable tax policies.

Commercial buildings and facilities, including shopping centers, are in particular need of energy tax credits as a result of the denial of such credits by the IRS for such energy property as automatic energy control systems. These systems produce major energy savings by substantially increasing the efficiency of heating and cooling equipment yet the IRS refuses to permit use of the credit in commercial buildings based on an excessively restrictive interpretation of the Code--an interpretation clearly not supported by the legislative history of the Energy Tax Act.

B. Recommendations. The Administration has proposed to repeal the credit for all energy property--both conventional and unconventional--on December 31, 1982. ICSC suggests that extension and expansion of the business energy credits is necessary to maintain the progress toward conservation which has occurred. Specifically, ICSC urges that Congress make clear that specially defined energy property is eligible for this credit when installed in commercial retail space, that the conventional credits be extended through 1986, and that the credit be increased from 10 to 20 percent. H.R. 4912, the Commercial Business Energy Tax Credit Act, which is now pending in this Committee, would accomplish these objectives. The ICSC urges that the provisions of this bill be enacted.

V. INDUSTRIAL REVENUE BONDS (IRBs)

A. Role of IRBs in Shopping Center Development. As with other construction industries, shopping center development has in the past been dependent upon financing at rates which are consistent with affordable rents. Present market conditions have by and large dictated what we hope will prove to be a temporary end to conventional financing and, therefore, a temporary end to conventionally financed shopping centers.

The ICSC submits that the availability of industrial revenue bond financing, with the limited tax exemption afforded under Internal Revenue Code §103(b), has allowed shopping centers and other commercial and industrial facilities to be built in communities that would otherwise remain without the clear social and economic benefits directly attributable to those facilities.

IRB financing has been crucial to the development of small and medium sized shopping centers of up to 200,000 square feet of gross leaseable area. These are the centers which represent the commercial heart of countless communities throughout the country, and they would have gone unbuilt but for the capital resources made possible (or at least more accessible) through IRB financing. The ICSC believes that the communities served by these facilities are economically better off today than they would have been without them. For example, in 1979, ICSC member M.H. Hausman Co., an Ohio developer of commercial facilities, built two shopping centers with industrial revenue bond financing. The company reports that neither of these facilities would have been built if the sole financing method available to the company had been conventional mortgages at prevailing interest rates.

Although the IRB rates and conventional rates have risen three to four percent since the facilities were built, a review of the income and expenses associated with one of M.H. Hausman's shopping centers illustrates the critical importance of IRB financing. The company's Columbia-Detroit shopping center in Westlake, Ohio, comprising some 50,000 square feet of gross leasable area, was financed through a $2.0 million IRB mortgage bearing an interest rate of 7 1/2 percent.

As figure 2 shows, the annual debt service of $181,632 on the mortgage, combined with general and miscellaneous expenses, yields a net annual cash flow to the shopping center owner, after deduction from rental income, of $34,197. A 14 percent mortgage, on the other hand, would result in an annual debt service of approximately $289,000. That mortgage expense would, even with all other expenses remaining the same, produce an annual loss in excess of $74,000, and would therefore have dictated that the Columbia-Detroit shopping center not be built.

A similar analysis of income and expenses for the second of M.H. Hausman Co.'s IRB-financed projects reflects the same devastating effect of high mortgage interest rates. The Crossroads Plaza in Saybrook, Ohio, had more than 70,000 square feet of gross

Figure 2.

	IRB Financing		Conventional Mortgage Financing	
INCOME				
Fixed Rent		$220,176		$220,176
EXPENSE				
Mortgage	$181,632[a]		$289,000[b]	
General Expense-Net Recovery	3,800		3,800	
Miscellaneous Expense	2,400	187,832	2,400	295,200
Net Cash Flow (Loss)		$ 34,197		$(74,824)

[a] $2,000,000 principal amount, 7 1/2 percent interest, 24 year term.

[b] $2,000,000 principal amount, 14 percent interest, 25 year term.

leasable area, and produced a net cash flow of $39,358. If M.H. Hausman Co. had been unable to obtain the 7 1/2 percent IRB-backed mortgage available at that time and been forced to proceed at the prevailing 14 percent mortgage rate, the positive cash flow would have been transformed into a net loss of $115,442 per year.

Of course, it might be argued that these illustrations show nothing more than that present market conditions justify higher rents to offset a developer's rising mortgage costs. As a practical matter, however, tenants of retail facilities are strictly limited in their ability to bear the burden of increased financing costs.

In deciding whether or not to lease space in a proposed shopping center, prospective tenants invariably focus on their projected return on investment. Although methods vary from one retailer to the next, analyses of returns on investment consider such factors as the estimated sales in the proposed facility, the expense of doing business, the anticipated profit, and a comparison of that profit to the total investment to be made in the new facility.

Clearly, rent is an important component of a tenant's expense of doing business. Thus, a proposed shopping center that cannot keep lease payments within the range required by a prospective tenant's return-on-investment analysis will not get built or will be delayed until interest rates fall to a level that will allow for rents which will permit the retailer to operate at a profit.

In the interim, people who could have been working will not be working, personal and business income taxes that could have been collected will not be collected, state and local taxes that could have been collected will not be collected, manufactured goods that would have been purchased and used will not be purchased, and so on.

The ICSC believes that these illustrations demonstrate that the net effect of eliminating or reducing the availability of small-issue IRB financing for retail facilities will be a substantial reduction of new construction starts in retail facilities. Concomitant with that reduction will be the loss to local treasuries of significant tax revenues. For example, the two relatively small shopping centers built by M.H. Hausman Co. discussed above are expected to generate total combined real estate and sales taxes of approximately $67,000 per year at full occupancy.

Of course, that $67,000 is calculated without regard to the very significant local revenues arising out of increased employment (estimated at 240 to 300 new jobs) and the secondary development that may be spurred by the introduction of the new retail facilities.

B. Limitation Upon Certain Uses of Small Issue IRBs. As previously indicated, any distinction between commercial and industrial uses of IRBs is counterproductive. Without a viable and healthy network of retail plant, no increase in manufacturing capacity will occur. Each segment of the economic system is interconnected and inadequate plant in one segment causes bottlenecks and blockages that ripple through the entire system.

The ICSC believes that IRB financing of shopping centers and other retail facilities contributes as much or more to both the economic wellbeing and quality of life of a community as does IRB financing of other links in the industrial and distribution chain.

For example, figures compiled by the New Jersey Economic Development Administration demonstrate that, at least in that state, IRB financing for commercial projects is a more effective means of creating permanent jobs than all other uses of IRB financing. As figure 1 indicates, the number of permanent jobs created per $1.0 million of industrial revenue bond financing for commercial projects (including retail facilities) was approximately one-third higher than the number of industrial jobs generated by the same dollar amount of IRBs.

Figure 1.

Project Type	Total New Jobs* 1980	Total 1980 Industrial Revenue Bonds Issued in Support of Projects ($000)	New Permanent Jobs per $1.0 Million of IRBs
Commercial (including retail)	1,613	$ 52,181.1	30.9
Balance of Projects, Excluding Office and Investment in Quasi-Public Utilities	11,131	$478,334.4	23.3

*Permanent (excludes construction).

Source: New Jersey Economic Development Administration, 1980 Annual Report 15-21.

C. Federal Tax Revenue Impact of Small-Issue IRB Financing. The Department of the Treasury projects future revenue gains as a result of its proposal to limit IRB financing, although even the Treasury projects a net revenue loss in fiscal 1983. ICSC suggests that the results of a 1980 study conducted by Norman Ture, currently Treasury Undersecretary for Tax and Economic Affairs, more accurately states the effect of such limitations.

Ture pointed out that assumptions such as those made by the Department of Treasury are unrealistic since they presume that there are no changes in economic activity in response to the tax change. Thus, they erroneously assume that the volume of private investment would be unaffected by eliminating the IRBs because each eliminated dollar of IRB-financed investment would be replaced by a dollar of taxable financed capital outlay.

However, if the amount of IRBs were deemed to be associated with additional investment--that is, with investment which otherwise would not be undertaken--the initial impact revenue effect would be zero, since no displacement of other financing would have occurred. Taking into account changes in economic activity in response to the tax change and the effects of these changes in the economy on tax bases, additional IRB financing results in net additions to the volume of capital formation, rather than displacement of taxable financed investment.

Clearly, the experiences of ICSC's membership bear out Dr. Ture's conclusion that "IDBs are productive instruments for promoting economic development by making saving and investment more attractive to individuals and businesses. Their use results in overall gains in capital formation, employment, and output, rather than merely changes in the location of economic activity."[2]

The Congressional Budget Office ("CBO") also has projected additional federal tax revenues through the elimination of small-issue IRB financing. However, in testimony before the House Ways and Means Subcommittee on Oversight delivered on April 8, 1981, Roger C. Kormendi of the University of Chicago challenged certain assumptions upon which the CBO based its estimates of the net loss to the federal treasury associated with IRBs. Kormendi, in a report prepared with Thomas T. Nagle, concluded that the cost of IRB financing in lost federal tax revenues is $4 to $6 million for each billion dollars of new IRBs when taxable interest rates are between 10% and 14%. Kormendi's estimates contrast sharply with the CBO's estimates of $30 to $40 million for each billion dollars of bonds.[3]

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[2] N. Ture, A Report Prepared for the National Committee on Small Issue Industrial Development Bonds: Economic and Federal Revenue Effects of Changes in the Small Issue Industrial Bond Provisions 11 (1980).

Furthermore, Kormendi estimates that each dollar of interest saving for IRB borrowers costs the U.S. Treasury approximately 15 cents in federal tax revenues. Thus IDBs are more than six times as efficient as direct subsidies, which cost the U.S. Treasury one dollar for each dollar of benefit. This conclusion contrasts sharply with the Treasury's claim that each new dollar of interest saving for IDB borrowers costs the U.S. Treasury $1.33 in federal tax revenues.[4]

It is important to note that these estimates of revenue loss are not, as Ture would say, "net-of-feedback." Kormendi points out that tax revenues depend not only on tax rates but also on the tax base. Since anything that encourages the tax base to expand will result in a higher feasible level of tax revenues in the future, the lower capital cost provided by the interest tax exemption will almost certainly lead to more investment and growth of the small business sector. Therefore, sales, property, and income tax revenues will grow.

D. Evaluation of Small-Issue IRBs. The ICSC suggests that any decision to preserve or eliminate the tax exemption for small-issue industrial revenue bonds should be made solely on economic merit. The ICSC membership is satisfied that a legitimate cost-benefit analysis, considering all issues relevant to ultimate impact on the national economy, would dictate not only the preservation, but the expansion, of the present tax exemption.

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[3] R. Kormendi and T. Nagle, A Summary of the Nature and Effect of Small-Issue Industrial Development Bonds 1 (1981).

[4] Id.

If it is correct that minimal or no net loss to the federal treasury arises from the availability of small-issue IRB financing, no other legitimate policy consideration would be served by curtailing access to that source of capital. At the very least, it would be inappropriate for IRB critics to pursue some hidden philosophical goals, whatever those may be, disguised as a legitimate effort to reduce federal budget expenditures.

Moreover, the ICSC points out that imposition of new limitations at this time of extraordinarily high interest rates freezes out new entrants into the real estate industry, diminishes employment, and reduces markets for manufactured products. The ICSC suggests the American consumer and the real estate industry will both benefit by encouraging new development rather than by discouraging it.

In addition, the CBO's recent study reflects the diverse criteria among states for the appropriate uses of IRBs within their borders. So long as the federal interest in governing IRB use is as minimal as the net effect of IRBs on the federal treasury, ICSC believes that the federal government should decline to engage in efforts to impose uniformity on the states' exercise of their authority to issue IRBs. If individual communities and states, as major benefactors of the increased revenues attributable to commercial development, choose to encourage particular types of commercial and industrial development, their will need not and should not be supplanted.

E. Recommendations. It is clear, both from the CBO's acknowledgment of the inadequate data underlying its recent report and from the ICSC's own efforts to develop comprehensive information on the use of IRBs, that Congress cannot now be fully informed on the economic merits of IRB financing. The ICSC, therefore, recommends that reporting requirements be imposed at the state level on all users of industrial revenue bonds.

With respect to the specific proposals of the Administration, ICSC supports the requirement that a local elected official or legislative body approve the issuance of a bond and the requirement of a public hearing prior to such issuance. In addition, ICSC suggests that annual reports be required containing information on the amounts of IRB financing provided; the number of jobs created per million dollars of IRB issuance; wages, FICA taxes, and federal, state and local income taxes associated with these jobs; and property taxes and sales taxes generated by IRB-financed projects. ICSC is also prepared to meet with Members of Congress and the Department of Treasury to discuss excluding from IRB financing certain offensive uses.

The ICSC strongly believes that denying IRB financing to larger businesses totally misconceives the function of IRBs. They are not a subsidy to the developer or user but are intended to provide a community with economic development, increased jobs and tax revenues it would otherwise not enjoy. No matter how big or financially secure a corporation is, it has no incentive to invest in a particular community unless the deal will show a profit. IRBs are necessary to make the deals work in many communities, particularly those most in need of increased employment.

ICSC is very concerned, however, that the effect of other administration proposals will be to deny local communities the benefits of much needed facilities that depend upon IRB financing. In particular, the requirement of a local contribution imposes a financial burden on those hard pressed communities most in need of new investment. Similarly, the proposed small business limitation, to the extent it reduces investment and development, deprives local communities of the benefits of new investment.

Recently, the ICSC surveyed eleven of its members as to the effect of the small business limitation upon shopping center construction and operation. The members reported that the limitation would effectively prohibit the traditional anchor stores of small and medium shopping centers--groceries and drug stores--from participating in an IRB financed facility. Thus, communities would be the ultimate losers of such a limitation.

The requirements that facilities financed by tax-exempt bonds use straight line cost recovery methods and extended recovery periods for purposes of computing earnings and profits is particularly damaging since it substantially reduces the yield on investment to a degree which may make the entire project unfeasible. Finally, ICSC suggests that the arbitrage limitations and registration requirements result in additional and unnecessary costs to the developer and, with respect to the arbitrage limits, further suggests that the current law is adequate.

We generally recommend that the relative benefits of IRB financing are so great that Congress should encourage increased use of IRBs, whether through raised capital expenditure limits or other means, to finance commercial and industrial projects. ICSC submits that certain provisions of Internal Revenue Code §103(b) have imposed inequitable and unnecessary conditions on the availability of IRB financing. The current $10 million capital expenditure limit applies, under §103(b), to all facilities that are located in the same municipality or county and associated with the same principle user or users.[5/] The jurisdictional limitation of §103(b) should be modified to allow additional capital expenditures for industrial or commercial projects in areas where higher population would suggest a greater demand for those projects. The ICSC recommends, therefore, that the Congress respond to the needs of those populous communities by permitting higher capital expenditure limits in jurisdictions where population levels exceed a specified level.

Finally, it is a particularly bad time to consider restricting the use of IRBs. All agree the economy is in a very serious recession and that the major program the Government has proposed to end the recession is increased investments from the private sector. Unfortunately, this plan is not working, and the President has identified high interest rate as the reason. IRB financing offers the only escape valve that permits some development to continue at below market interest rates. In many places, IRB financing is "the only game in town." Restricting IRBs at a time when high interest rates are frustrating the economic recovery plan will serve only to worsen and prolong the recession.

[5/] I.R.C. §103(b)(6)(E).

STATEMENT
OF
THE NATIONAL ASSOCIATION OF HOME BUILDERS
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
ON
THE ADMINISTRATION'S TAX PROPOSALS
APRIL 2, 1982

Mr. Chairman and Members of the Committee:

My name is Fred J. Napolitano, and I am a homebuilder from Virginia Beach, Virginia. I am testifying today on behalf of the more than 114,000 members of the National Association of Home Builders (NAHB). Mr. Chairman, since November of 1981, NAHB has suffered a loss of over 9,000 members. NAHB is a trade association of the nation's homebuilding industry, of which I am President.

I appreciate the opportunity to present our views on the Administration's tax proposals for 1982. Before I comment on the specifics of these proposals, I would like to outline for the Committee in some detail, the state of the housing industry today.

HOUSING PRODUCTION

- New housing production in 1981 totaled 1.1 million units as against an annual need for new homes that has been estimated conservatively at 1.8 million units throughout the 1980s. Last year was the worst housing production year since 1946.
- 1982 could finish as the worst post-war production year yet. NAHB's optimistic

forecast for this year holds annual production to about 1.17 million. Housing starts in February fell to a seasonally adjusted annual rate of 953,000, down 26 percent from a year earlier, and down more than 50 percent from the two million annual production levels in 1977 and 1978. February was the seventh consecutive month that housing starts were below the one million annual level.

° March is the 40th month of recession in housing. The previous record was set during the Eisenhower Administration when the housing recession lasted 27 months.

NEW HOME SALES

° 1981 was the worst year for new home sales since the Census Bureau began collecting statistics in 1963. Only 436,000 new homes were sold, compared to 545,000 homes in 1980 and more than 800,000 in 1977 and 1978.

° Since March 1981, annual new home sales rates have been under the 500,000 level. In February this year, the annual sales rate of new homes was 336,000, the second worst sales rate on record.

° Actual sales in February nationwide were 26,000 new homes -- roughly the monthly number of new homes that were sold in the West alone during 1978 and 1979. In all of the Western states, only 7,000 new homes were actually sold in February. Only 6,000 new homes were sold in the Northeastern and North Central states combined.

INTEREST RATES

° Conventional mortgage interest rates now average 17.50 percent. Mortgage rates at such high levels price the vast majority of potential buyers out of the market.

- Interest rates normally fall rapidly and decisively during recession, but in this downturn they have declined slowly and have remained in an historically high range. Analysts forecast that mortgage rates are not likely to drop below 15 percent this year, thereby killing off any chances for a housing recovery in 1982. The consensus is that home sales will remain at depresesion levels until mortgage rates drop to the 12 percent range, which by historical standards still represents an extraordinarily high cost of home financing.

- By reducing interest rates from 16 percent to 12 percent, 4.6 million additional families could qualify for a $65,000 mortgage. At 12 percent interest rates more than 22 percent of the nation's families have the $35,000 income needed to qualify for a modest $65,000 mortgage. At 16 percent fewer than 14 percent have the $44,000 income needed to qualify for the same mortgage amount.

UNEMPLOYMENT

- Unemployment in the construction trades in March was 17.9 percent or 928,000 unemployed workers, accounting for 9.4 percent of the total unemployed work force. Another 200,000 skilled craftsmen could lose their jobs over the next several months.

- An estimated 200,000 self-employed people in construction-related businesses have either shut down or sharply curtailed their operations in the housing industry. Self-employed people are not counted in the Labor Department's unemployment statistics.

- Bankruptcies are up 33 percent for construction firms and 65 percent for contractors.

- Rising joblessness toward levels not experienced since the 1930s continues to feed the federal deficit. The Congressional

Budget Office estimates that every one percent increase in unemployment costs the Treasury $25 billion -- $19 billion in lost revenue and $6 billion in new expenditures to pay for unemployment programs.

U.S. v. THE WORLD

New housing production in the United States is outdistanced by almost every industrialized nation and the Soviet Union. Among the major western nations only Great Britain has recently been investing less in its housing stock than the U.S.

- In 1946, seven housing units were produced per 1,000 of U.S. population. Last year, the U.S. rate fell to only 4.8 starts per thousand. In the U.S.S.R. last year, housing production was reported at eight units per thousand.
- 1981 housing production in Japan was higher than in the U.S., even though it has roughly half the population. And they thought they were in the midst of a downturn!
- In 1981, private residential investment in 1980 was only 3.6 percent of the nation's Gross National Product, compared to 6.8 percent in France and West Germany, 6.5 percent in Japan, five percent in Italy and 4.8 percent in Canada.
- According to the Federal reserve Board, housing's share of the credit markets has declined from 31 percent in the 1950s and about 25 percent in the 1960s and 1970s to only 16.4 percent in 1980-81. By comparison, the federal government's share has increased from 7.7 percent in the 1950s to almost a third last year.

Mr. Chairman, these statistics show with no uncertainty the critically depressed state of our industry. Unless and until mortgage interest rates are reduced to affordable levels, our industry will not show any signs of recovery. I am sure this Committee is aware that in the past seven recessionary periods, it has been the housing industry that has led the overall economy out of recession.

REDUCE FEDERAL DEFICITS

The only long-term solution to bringing down interest rates is by reducing the federal deficit. The prospects of a $100 billion plus deficit for the coming fiscal year is only made worse by out-year deficit projections of $400-500 billion. We support the Administration's desire to improve the efficiency of its revenue collection system as an element of its program to reduce the deficits. However, there are some elements of the Administration's tax proposals which we believe will hinder the ability of small businesses, such as homebuilders, to conduct business. Rather than increasing federal revenues, such proposals may serve to inhibit businesses and possibly reduce revenues.

I. CORPORATE MINIMUM TAX

Under present law, corporations are required to pay an "add-on" minimum tax, so called because it is added to the corporation's regular income tax, equal to 15 percent of certain items of tax preference.

PROPOSED CHANGES

Effective January 1, 1983, the present add-on corporate minimum tax would be replaced with a new 15 percent "alternative" minimum tax on "adjusted corporate profits" in excess of $50,000. The new tax would be an alternative tax in the sense that corporations would be required to pay it only if it exceeded their regular corporate income tax, in which event they would not pay the latter tax.

"Adjusted corporate profits," the base to which the 15 percent rate would apply, would be calculated by adding back to a corporation's taxable income (excluding net operating loss carryovers or carrybacks) the same tax preference items that are subject to the [illegible] minimum tax other than long-term capital gains, [illegible] addition to several new preference items.

No credits other than the foreign tax credit would be allowed to offset the new minimum tax. The excess of the minimum tax paid in any year over the regular corporate income tax liability calculated for that year could be carried over for 15 years as a credit against the regular tax.

THE PROBLEM

Items of Tax Preference

Among the items of tax preference to be added to taxable income in determining the proposed base for the new minimum tax would be an amount equal to the excess of accelerated depreciation over the amount that would have been allowed had the straight-line method been utilized. This same amount is now an item of tax preference in the computation of the add-on minimum tax.

NAHB has opposed the treatment of this amount as a tax preference item since the enactment of the add-on minimum tax in 1969. Such treatment constitutes a penalty imposed upon businesses that engage in real estate activity. The Administration proposes to continue this penalty under its new alternative minimum tax on corporations.

In the view of NAHB, the continuation of such treatment of accelerated depreciation would be as unwise as it would be unfair. At the present time, the home-building industry is in a more depressed condition than at any time within memory. Under the circumstances, the prudent tax policy would be to encourage the home-building industry rather than to penalize it. This is especially true since it is upon the recovery of the home-building industry as much as any other economic development that a general improvement in the economy will depend.

Accordingly, NAHB urges this Committee to reject the Administration's proposal to include accelerated depreciation of real property among the tax preference items that will be subject to the new alternative minimum tax on corporations. Moreover, if the Committee should decide to retain the present add-on minimum tax, NAHB urges the Committee to vote to terminate the inclusion of such accelerated depreciation as a tax preference item under that tax. We emphasize that in calling for such action, NAHB is not requesting creation of a new tax benefit to favor the home-building industry but merely advocating the removal from the tax code of a discriminatory provision.

Another item that the Administration proposes to include as a tax preference item subject to the new minimum tax on corporations is a portion of current deductions of certain indirect costs incurred with respect to long-term contracts entered into on or before February 26, 1982, and reported under the completed-contract method of accounting. As is well known, the completed-contract method of accounting is widely utilized within the home-building industry. The inclusion of such costs among tax preference items subject to the corporate minimum tax will have an adverse effect upon the home-building industry. The same economic conditions that require elimination of accelerated depreciation of real property as a tax preference item also counsel strongly against adoption of these costs as a tax preference item.

Furthermore, even if these adverse economic conditions did not exist, the Administration's proposal is highly unfair. Taxpayers who previously entered into long-term contracts undoubtedly relied upon the estalished tax rules in computing their prospective economic gains from the contracts. One of the factors that will have entered into such computation is the tax liability to which performance of the contracts would give rise. If Congress were now abruptly to increase that liability, as it would do if some of the contract costs were subjected to the proposed minimum tax, the planning of these taxpayers would be substantially frustrated. In the view of NAHB, such disregard of the legitimate economic expectations of taxpayers is unreasonable and inequitable.

Accordingly, NAHB urges this Committee to reject the Administration's proposal to include the previously described costs within the tax preference items subject to the new minimum tax.

Effective disallowance of Net Operating Loss Carryforwards

In computing the corporate minimum tax base, no deduction would be permitted for net operating loss carryovers and carrybacks. Although credits for the minimum tax paid would be permitted, the amount of any NOL carryover or carryback allowable in computing the regular corporate tax would be deemed to be "absorbed . . . even in years in which the corporation pays the corporate minimum tax instead of the regular tax." Effectively, the NOL carryover is denied in computing the minimum tax.

This effect is illustrated by the following example:

Home Construction Corporation had no taxable income during 1981 and 1982, but instead suffered losses of $100,000 in each year. For those years, its regular tax liability is zero and its alternative minimum tax is zero. In 1983 it has $200,000 of income but, because of the NOL carryforward, the regular tax liability for that year is zero. It will still be assessed a $30,000 alternative minimum tax despite having no preference items of income because of the disallowance of the NOL carryforward.

Whatever the theoretical justification of disallowing NOL's in computing the new minimum tax, the disallowance imposes a greater burden on the housing industry than that imposed on most other industries. More than most industries, housing is traditionally cyclical in nature. The ability to utilize NOL carryovers permits homebuilders to have their tax assessed on the basis of their performance during an entire cycle rather than during each of the parts thereof, in which income may fluctuate dramatically. Separating the profitable periods out from the cycle and imposing a minimum tax works manifest injustice to the home-building industry.

II. PROPOSED REPEAL OF THE COMPLETED CONTRACT METHOD OF ACCOUNTING

The completed contract method of accounting is one of two special long-term contract methods permitted under the regulations promulgated pursuant to section 451 of the Internal Revenue Code, the other being the percentage of completion method. In addition, there are presently available to the long-term contractor the usual methods of accrual and cash accounting.

A long-term contract is a building, installation, construction, or manufacturing contract which is not completed in the taxable year in which it commences. Homebuilding contracts generally will be categorizable as long-term contracts. However, manufacturing contracts normally are not considered long-term contracts unless the manufacture involves unique items, or items which usually take more than twelve months to complete.

Long-term contractors must elect a method of accounting with their initial Federal tax return filed. There is no conformity requirement, however, so that the method used for tax purposes may differ from that used for financial reporting purposes.

Present Law

The completed contract method of accounting deviates from normal accounting practices in an effort to more clearly reflect the economic experience of the long-term contractor. As opposed to normal annual accounting period concepts, income or loss under the completed contract method is reported on a contract-by-contract basis. The gross contract price is reported as income in the taxable year in which the contract is finally completed and accepted, even though payments are received throughout the course of the contract. In general, deductions for all expenses properly allocable to the contract must be deferred until the income is realized. Present regulations do, however, allow certain indirect costs to be deducted currently.

The regulations permitting the completed contract method were promulgated in 1918. During the intervening sixty years, the construction industry has achieved a high degree of stability and certainty with respect to its tax liability through cash management methods which have essentially eliminated the need for profit estimates. Now the Administration seeks to remove this certainty and impose greater record keeping burdens on the industry through imposition of the percentage of completion or progress payment method because of a desire to achieve a "better matching of income and deductions".

Administration Proposal

Legislative Proposal

The legislative proposal (1) would repeal the completed contract method and (2) remove the contractor's choice of the cash or accrual methods of accounting by providing that taxpayers must elect to use either the percentage of completion method or the progress payment method of accounting for long-term contracts. Under the progress payment method, most costs are allocated to long-term contracts and deferred until the taxpayer has a right to receive payment under a contract. At the time the right to payment accrues the taxpayer may deduct the total of the current and previously unclaimed costs allocated to a contract, up to the amount of the accrued payment. If the accrued payments exceed costs, the taxpayer would recognize the excess as income. Certain borrowings in lieu of payment are treated as payments.

Regulatory Proposal

The current regulations regarding accounting for long-term contracts would be amended in two main respects:

First, the regulations would be changed to require that, in the case of contracts accounted for by the completed contract method, all but a limited list of indirect costs will be allocated to long-term contracts and deferred until such contracts are completed. Included in this group of costs which would no longer be deductible by contractors are interest, pension, and general administrative expenses.

Second, the regulations would be amended to clarify when an agreement, or series of agreements, must be regarded as more than one contract.

Why the Completed Contract Method is Used

The construction industry is a high-risk, and, at present, a high-failure rate industry. Many of the small firms which comprise the bulk of the building constituency are relatively cash-poor and are subject to extreme competition. These market conditions narrow profit margins to an extent that is inconsistent with the market risks undertaken. In addition, most companies engaged in the construction of structures, whether residential or commercial, are closely-held, so that there is a commmensurate need for accurate and comprehensive tax planning in an economy that discourages the generation of operating capital in the credit markets.

Repeal of the completed contract method will subject the long-term contractor to taxation on unrealized, unearned and undetermined profits. By definition, the completed contract method is used only by those taxpayers entering into long-term contracts, i.e., those spanning at least two taxable years. Because of this extended period of performance, the possibility for necessary, substantial modifications is increased, especially in the construction of custom homes or buildings.

Seldom is it possible to determine the economic profit on a contract until its completion, due to the accumulated vagaries of the construction business. The work performed by contractors is usually performed on sites not subject to the complete control of the contractor. Completion of the contract may be delayed by jobsite mishaps, inclement weather, strikes, price increases, bankruptcy of subcontractors or suppliers, latent defects, failure of owners to pay, outstanding claims, litigation and other causes. Also, because every construction job is different, the ability of the homebuilder to enjoy the benefits of "economies of scale" and mass production, available to other industries, is substantially diminished.

In the face of such uncertainty and variety of construction conditions, any method of pricing which relies on estimating costs with the addition of a reasonable profit is inherently inaccurate. In effect, prices are fixed before costs are accurately determined. Even in the case of cost-plus contracts, in which a contractor receives reimbursement for costs incurred plus a reasonable profit, not all costs can be anticipated, and may not be reimbursable under the terms of the contract.

Because it is common for receipts to lag behind expenditures on a particular job, contractors require interim operating funds to maintain the steady progress of work. Often this is accomplished through drawing on receipts from other, concurrent projects, and often through bidding methods which allow certain costs to be "front-loaded" so that sufficient operating capital can be assumed over the life of the project.

If anticipated, and possibly overstated profits, are prematurely subjected to income taxes when received rather than when actually and economically earned, contractors will be forced to augment their cash flow through the use of borrowed funds (if available) in a time of unprecedented interest rates. Additional expense due to interest charges, incurred when the normal "retainage" (withholding of funds) by the owner typically approximates 10 percent of the contract price (often more than the total anticipated profit of the job), is incongruous when tax on a speculative profit is paid in real dollars. (It should also be recognized that the costs accumulated on a contract, unlike an accumulation of inventory, have little marketability or worth in the absence of application to a specific project. Thus the collateral value of such "assets" in the credit market is minimal.) If, notwithstanding the difficulties in obtaining loans for operating capital, a contractor is able to obtain such funds, the Administration proposes to tax the loan proceeds as income. Not only will this further aggravate the contractor's operating difficulties, but it is a drastic departure from basic principles of Federal income taxation.

It is unreasonable to believe that these increased costs, due to the cost of borrowing, and the added costs incurred and passed on in turn by subcontractors on the job, who will also be precluded from using the completed contract method, will not eventually be paid by the homebuying public. It is submitted that the end result will be cost accelerations greater than the implicit cost to the government of the present tax deferral.

The Administration proposes the destruction of an acounting method that has been expressly authorized for over 60 years. We suggest that given the longevity, stability and appropriateness of the method, the Administration's appproach of total repeal cannot be justified.

Administrative changes in Treatment of Indirect Costs

Present Law

Under the regulations promulgated pursuant to section 451, all direct costs attributable to the contract, and most indirect costs "incident to and necessary for the performance of particular long-term contracts" must be allocated to the contract; thus deductions for such costs are deferred until the taxable year in which income from the contract is realized.

Expenses that are not attributable to specific contracts, that is, those which benefit the taxpayer's business as a whole, or those which Congress has determined to be of such importance that they should be currently deductible, are not required to be allocable to the contract. The Treasury Department now proposes to drastically alter the treatment of these currently non-allocable, indirect expenses, so that an "all indirect costs that directly benefit the performance of long-term contracts and an appropriate part of all other indirect costs must be allocated to long-term contracts."

In seeking to overthrow the carefully crafted rules relating to the allocation of indirect costs, the Treasury Department is repudiating the results of a careful dialogue between industry and the Department between 1971 and 1976. NAHB believes this effort to be ill-advised, both in terms of administrative complexity and its effect on contractors' ability to deduct ordinary and necessary business expenses vis a vis other industries that do not engage in long-term contracts.

Some of the more important period costs which are proposed to be allocated in some, as yet undetermined manner, include the following:

1. Pension Costs

Under current regulations, pension costs and other indirect costs incurred by a taxpayer in the performance of long-term contracts and construction of capital assets are deductible currently even though the taxpayer is utilizing the completed contract method of accounting. See Treas. Reg. §1.451-3(d)(5). Further, this treatment has been a part of the tax law for at least 42 years. See I.T. 3408, 1940-2 C.B. 178. Representatives of the Internal Revenue Service have on numerous occasions admitted the appropriateness of allowing current deductions for pension costs. See, e.g., Commissioner v. Idaho Power Company, 418 U.S. 1 (1974). (It should be noted that the Internal Revenue Service has, for approximately four years, had a project to consider the capitalization of certain pension costs as they relate to the construction of capital assets. We understand that project is still undergoing preliminary consideration.)

As part of its proposals, the Administration has suggested that by regulation pension costs should no longer be currently deductible but should be allocated to the long-term contracts with which they are associated. An exception would be provided, however, for past service pension costs. See General and Technical Explanation of Tax Revisions and Improved Collection and Enforcement Proposals at 7 (February 26, 1982). The Administration has also suggested that this new treatment be applicable legislatively to the progress payments method and percentage of completion methods to be adopted by Congress.

The National Association of Home Builders strongly believes that the changes suggested by the Administration with respect to pension costs are entirely inappropriate and should not be adpoted either legislatively or regulatorily. Further, we suggest that this Committee direct the Internal Revenue Service not to change its regulations until Congress has had an adequate opportunity to fully review this matter. We further suggest that even if the percentage of completion or progress payments method is adopted legislatively, such legislation permit the current deduction of pension costs for the reasons we will describe.

The treatment of pension costs suggested by the Administration is inappropriate and arbitrary, and will create substantial complexity. Those who developed the proposal apparently made the assumption that pension costs are like wages and can be readily allocated to specific projects. In fact, pension costs are totally unlike wages in that they cannot reasonably be associated with periods of employment spent on particular projects. Further, the distinction made by the Administration between past service costs and current costs is, in reality, arbitrary. These funding distinctions were developed as a method of spreading costs, not as a means of identifying periods to which the costs relate. As the current regulations recognize, pension costs relate more to the employee's total period of employment. The precise method of funding those costs has little or no bearing on the period to which those costs relate. Further, if such allocations were required, unrealistic distortions and complexity in the handling of pension costs would result. This would be especially true where employees are moved from job to job.

The rules in the Internal Revenue Code regarding pension plans have been carefully developed over many years under a system that assumes costs are deductible currently. For example, employers are allowed deductions within specified limits under section 404(a) of the Internal Revenue Code. The capitalization of pension costs would distort the system for placing limits on both the funding and deduction of pension costs because of the bunching that would result. These distortions would have adverse effects on the entire design of the pension system.

Perhaps the strongest argument against changing the treatment of pension costs for taxpayers utilizing the completed contract method of accounting is that it would undermine the national policy of providing major incentives for the adoption and continuation of pension plans. Providing retirement income to employees is perhaps the strongest incentive endorsed by the Internal Revenue Code. Specific rules have been adopted to ensure that pensions are provided to employees on a nondiscriminatory basis and to strongly encourage employers to adopt pension programs so that employees will receive adequate retirement income. The need to expand pension coverage was strongly endorsed recently by the President's Commission on Pension Policy. See, for example, Coming of Age: Toward a National Retirement Income Policy (February 26, 1981). The Commission also emphasized the need for a uniform national policy encouraging increased coverage of workers. The Administration's proposals on pension costs for taxpayers using the completed contract method of accounting would not only undermine the need for a uniform national policy, they would also directly conflict with the goal of encouraging employers to establish nondiscriminatory plans to provide adequate retirement income for employees.

2. Interest

Section 163 specifically provides for the deduction of interest. Section 266, in turn, limits the capitalization of carrying charges, such as interest, to specific circumstances at the election of the taxpayer. These Code sections and others illustrate the acknowledgement by Congress of the current deductibility of a charge for the use of money over time.

Despite these legislative precedents, the Treasury Department would allocate interest to particular long-term construction contracts and require it to be capitalized for deferred deduction only upon completion of the contract.

Practically, allocation of interest to long-term contracts presents problems due to the general practice of funding several ongoing projects through incurring debt. The basic problem is choosing a rational allocation system. The possible allocation of interest on the amount of billings per project for the taxable year, for example, ignores the wide flexibility in the industry reflected in advance payments, mobilization payments, and front-loaded contracts.

The regulations under Section 861, designed to deal with a similar problem -- the allocation of interest expenses between foreign and domestic income -- state that the interest deduction should be most accurately apportioned on the basis of asset values. The feasibility of transferring a like standard to long-term contracts is not at all assured. Costs in excess of billings, i.e., asset values, are recorded, but are poor reflections of actual income producing capacity. If these complex and inapproriate rules are not adopted, the Treasury may fall back on an allocation system grounded on "estimates" of income, precisely the uncertainty that the completed contract method is designed to avoid.

3. Officer Compensation

Under current regulations, when management level personnel directly perform services attributable to specific projects, allocable expenses are capitalized. The more difficult situation, at least administratively, is raised by the Treasury's attempts to allocate officers' compensation attributable to time and effort devoted to activities which unquestionably benefit the company, but cannot legitimately be claimed to correspond to any one project.

For example, long-term corporate planning is undertaken for the benefit of the entire company, not for a particular job, and not necessarily for a particular taxable year. We submit that any proposed allocation method in this area would be arbitrary and therefore administratively burdensome.

4. General and Administrative Expenses

These expenses conceptually do not contribute to the completion of particular contracts, but benefit the performance of the enterprise through maintenance of the capabilities to pursue such contracts successfully. They represent, in effect, the costs that must be paid by every business, whether involved in the long-term contract or simple service-oriented businesses. Administrative costs -- overhead -- which can be allocated, already are capitalized under the existing regulations. To require more would penalize businesses engaged in long-term contracting by denying them current deductions enjoyed by their counterparts in industry.

III. DEDUCTION OF CONSTRUCTION PERIOD INTEREST AND TAXES

Present Law

Subject to certain exceptions, amounts paid or accrued as interest and taxes in connection with the construction of real property held for business or investment purposes must be capitalized and amortized ratably over specified periods, as set forth in Section 189 of the Internal Revenue Code. Exceptions to this rule include 1) amounts paid or accrued in connection with the construction of low-income housing, and 2) a general exclusion for corporations; that is, corporations that construct real estate may currently deduct the interest and tax costs as they are incurred prior to the time the property is placed in service or offered for sale.

Administration Proposal

The Administration, in its General and Technical Explanation of Tax Revisions, includes a proposal to amend section 189 to require that corporations capitalize interest and taxes incurred in the construction of non-residential buildings and recover them ratably over a 10-year period. Thus, one-tenth of the interest and taxes incurred during a construction year may be deducted in that year; the remaining nine-tenths would be deducted ratably in each of the nine years beginning with the taxable year in which the building is ready to be placed in service.

The position of the National Association of Home Builders, as has been consistently maintained, is that section 189 should be repealed in its entirety, and that construction period interest and taxes should be currently deductible. In this connection NAHB wishes to applaud the role played by this Committee in exempting permanently from the application of Section 189, construction period interest and taxes paid or accrued with respect to low-income housing for taxable years beginning after December 31, 1981, which provision was included in the Economic Recovery Tax Act of 1981.

In the face of this moderating provision, the Administration has now proposed to restrict the ability of corporate taxpayers to currently claim deductions for taxes and interest incurred during the construction period.

Taxes are a recurrent expense; tax bills recur yearly, and are paid as they are issued. In other businesses, a deduction is allowed for taxes in the year in which they are paid. The same is true for construction period interest payments. Construction interest is attributable to a construction loan that exists only during the twelve to twenty-four month period when a multifamily housing project is under construction. When construction is complete, the construction loan is paid off, a new permanent take-out loan is issued and a new, recurring interest charge begins. The real estate industry is discriminated against by not being allowed the deduction in the year in which construction period tax payments are made.

We can see no justification for capitalizing construction period interest and taxes. These items are akin to current expenses. The provisions of the Code prior to their amendment in 1976 provided incentives necessary to attract investment to an industry already suffering a shortage of capital. So long as there is no attempt to avoid legitimate taxes by prepaying interest attributable to other periods, interest and tax deductions should be allowed in the year in which payments are made.

We are concerned by the statement in the General and Technical Explanation that "there is no econmic policy or tax administration reason why corporations should not be subject to the same rule as individual taxpayers in [regard to section 189.]" This assertion denies the very legislative basis on which the Congress amended section 189 in 1976 to preclude abusive tax shelter schemes. Before then real estate ventures were formed to allow a pass-through of tax benefits sufficient to draw needed capital to an important industry. Congress felt that in some cases these benefits were too rich and foreclosed the ability of individuals, partnerships, and subchapter S corporations to currently deduct construction period interest and taxes. They specifically acknowledged, however, the lack of abuse in the corporate area, primarily because of the inability to pass-through benefits to individuals, but also because of a realization that benefits stimulating housing construction are essential. We submit that the Treasury Department errs in its current analysis of the economic policy justification of section 189.

Furthermore, the Treasury Department alludes to possible clauses in section 189 through attempts to evade the proposed elimination of the completed contract method of accounting. As we have stated, these changes are unwarranted. They should not be adopted; nor should restrictions in section 189 be the medium through which such fractious revisions are promulgated.

While we appreciate the exclusion by the Administration from the revised proposal of residential real property, we urge this Committee to scrutinize carefully the rationale behind the Administration's limited proposal. After careful evaluation we believe this Committee will recognize that the Administration's proposal, and indeed section 189 itself, are not justified.

IV. TAX EXEMPT REVENUE BONDS

Present Law

The Mortgage Subsidy Bond Tax Act of 1980 was enacted generally to direct the subsidy from the use of tax-exempt bonds for housing to those individuals who have the greatest need for the subsidy, to increase the efficiency of the subsidy, and to reduce the overall revenue loss to the Federal Government from the use of tax-exempt bonds for housing.

Industrial development bonds for multi-family rental projects

Definition of "low or moderate income". Tax-exempt industrial development bonds may be used for multi-family rental projects only if 20 percent of the units (15 percent in targeted areas) are occupied by individuals of "low or moderate income", as defined in section 8 of the United States Housing Act of 1937.

Duration of targeting requirement. The 20-percent requirement (15 percent in targeted areas) must be met for 20 years with respect to any obligations issued before January 1, 1984.

Administration Proposal

The Administration's proposal to restrict industrial development bonds has four major provisions that threaten the viability of revenue bonds as a source of alternative multifamily housing financing.

- The use of accelerated depreciation is eliminated when tax-exempt bonds are used to finance rental housing developments.
- Issuers will no longer be allowed to earn arbitrage on bond proceeds invested during the temporary construction period and reserve funds. Bond issuance costs may not be taken into account in determining the yield for the purposes of the arbitrage limitation.
- After 1985, the governmental unit must make a contribution to the facility financed with tax-exempt bonds equal to one percent of the face amount of the bonds.
- Bond issues are subject to public review and approval by the highest elected official or legislative body.

Clearly, the most damaging proposal is the elimination of depreciation benefits provided by the Accelerated Cost Recovery System. In the absence of accelerated depreciation, there will be a substantially reduced inducement for investors to place their capital in low and moderate rental housing. The use of accelerated depreciation is necessary to offset the high risks associated with investing in rental housing production.

The Administration recommends the elimination of the unlimited yields issuers currently earn on proceeds during the temporary construction periods and on reserve funds. These positive earnings on reserve funds and funds held during construction have been used solely for the benefit of developments, such as to cover mortgage arrearages, and do not flow to the issuer. Rather, they act as a vital insurance fund providing security to bondholders.

Interest rates on bonds can be expected to increase as a result of inadequate security. The net effect, therefore, may be an increase in mortgage rates. According to a recent study of the 1980 Mortgage Bond Subsidy Act, the Congressional Budget Office concludes that interest rates, and subsequently, mortgage rates, may have been adversely affected by tight yield restrictions. A similar negative impact on multifamily mortgages can develop if the Administration's yield provisions are adopted.

Even with investment earnings, issuers have had to contribute their own administrative funds to cover debt service payments. This will be further exacerbated by the Administration's proposal requiring a contribution equal to one percent of the face amount of the bonds after 1985. Since states and localities are undertaking substantial risks in financing low and moderate income households, it is unconscionable to require this additional contribution, particularly for less affluent states and localities.

Finally, the public review requirement will add yet another regulatory burden to the issuance of rental housing bonds. This requirement is directly contradictory to the Administration's position on deregulation, which we generally support.

Thus, the National Association of Home Builders adamantly opposes the Administration's proposed restrictions on the use of tax-exempt multifamily mortgage revenue bonds. The Administration has also recently proposed the elimination of federal subsidies for new construction to provide housing for low and moderate income households, although an estimated 400,000 starts in multifamily units are needed each year throughout the 1980's. Given this projected need, effective vacancy rates of less than two percent and unprecedented high unemployment in the construction industry, the continuation of a workable mortgage revenue bond program is essential to provide adequate housing for tenants who will otherwise not be served by the marketplace.

The Administration argues that "the volume of tax-exempt bonds for non-governmental users has grown rapidly during the past five years." This does not apply, however, to multifamily reserve bonds. In 1978, $5.6 billion in multifamily bonds were issued, whereas this figure declined to $4.1 billion in 1980, and $3.7 billion in 1981. Furthermore, the issuance of multifamily bonds is small in comparison to other industrial development bonds. Small issue IDBs grew from $1.4 billion to $10.5 billion from 1976 to 1981. Simultaneously, the growth in volume of multifamily reserve bonds was 50 percent, much of which can be atrributed to the government's heavy reliance on bond financing to support the Section 8 program. The usage of tax-exempt multifamily bonds has declined in accordance with reductions in Section 8 commitments. Thus, in absence of the Section 8 program, or a similar federal production program supported by tax-exempt bonds, it is anticipated tha the annual bond volume will not exceeed $1 billion given market constrictions.

As part of the Mortgage Subsidy Bond Tax Act of 1980, Congress agreed to restrictions on the usage of tax-exempt multifamily revenue bonds, specifying that 20 percent of the units in a multifamily development financed with these bonds must be preserved for low income persons, and that all rental housing bonds issued after January 1, 1982 must be in registered form. Following two years of debate on this issue, Congress concluded that multifamily bond issuance is not only costly and risky, but serves the public interest. Congress, therefore, exempted multifamily bonds from the strict restrictions imposed on single-family issuance, as well as the 1984 sunset.

The Administration is now suggesting the imposition of severe restrictions on multifamily bonds, although Treasury has yet to release regulations pertaining to the multifamily section of the 1980 law. Perhaps more perplexing, however, is the recent release of these restrictions when, in fact, the Administration is now focusing on liberalizing current restrictions on single family bonds to make the program workable. The public interest of our nation will unquestionably not be served by again imposing restrictions on the issuance of housing bonds, which, in effect, will terminate this program.

In light of the need for substantial expansion of the nation's rental housing supply, NAHB contends that it is unwise at this time to approve these provisions which will essentially eliminate the only financing mechanism available to support low and moderate income rental housing.

WITHHOLDING ON DIVIDENDS AND INTEREST

Mr. Chairman, NAHB opposes the Administration's proposal of a five percent withholding tax on interest and dividend payments made by individuals, partnerships, trusts and estates. We believe this proposal would be difficult to put into effect and the potential added revenue would not justify the additional costs of withholding. We urge the Committee to reject this proposal and to explore alternative methods of improving current information reporting requirements.

OTHER TAX ISSUES

NAHB supports the Administration's commitment to creating incentives for revitalization of economically depressed areas through "enterprise zones." While the Administration has not yet fully released the details of its program, we agree that tax incentives are a necessary component. We would also urge the Administration and the Congress to recognize housing as a priority in any enterprise zone proposal through a housing component.

INDIVIDUAL HOUSING ACCOUNTS

A major obstacle facing many potential homebuyers today is the inability to accumulate the savings necessary for a down payment. This is especially true for young families and first-time homebuyers. While individual retirement accounts provide a source of long-term savings, they do not take into account the needs of many families who do not have access to their savings before retirement, without paying a penalty. Individual Housing Accounts, such as S.24, introduced last year by Chairman Dole, would provide a workable savings incentive for housing down payments for first-time homebuyers. NAHB supports this concept, as well as a tax-free withdrawal from an existing IRA for the purchase of a first home as a principal residence.

MORTGAGE INTEREST DEDUCTION

Mr. Chairman, we appreciate your assurance of the importance of the homeowners mortgage interest deduction. This has been the cornerstone of the nation's commitment to homeownership since 1913 and your support and that of the full Senate serves to continue that commitment.

We apprecaite the Chairman's and this Committee's interest in housing and we hope to work closely with you this year on issues affecting our industry. I thank you for this opportunity to present our views on this important subject.

STATEMENT OF
THE BUILDING OWNERS AND MANAGERS ASSOCIATION INTERNATIONAL
ON THE
ADMINISTRATION'S TAX PROPOSALS
SUBMITTED BY
GARDNER McBRIDE
TO THE
COMMITTEE ON FINANCE
OF THE
UNITED STATES SENATE

April 2, 1982

I. INTRODUCTION

I am Gardner McBride, the executive director of the Building Owners and Managers Association International (BOMA). BOMA is an association of over 5,000 owners and managers of commercial office buildings comprising nearly one billion square feet of space. In addition, our members own or manage residential rental property as well as other types of nonresidential real estate.

II. THE STATE OF THE ECONOMY AND THE OFFICE BUILDING INDUSTRY

The United States is experiencing a period of high interest rates along with a deepening recession which has produced high unemployment and reduced capital investment in the commercial and residential segments of the real estate industry. The office building industry in particular has suffered the consequences of rising operating costs even though at the present time office occupancy rates are high relative to their levels of pre-1978.

I should note that about seventy percent of office space in the United States is concentrated in central cities.*/

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*/ Bennett Harrison. Urban Economic Development. Washington, D.C.: Urban Institute. 1974; p. 13.

Office buildings play a crucial role in the health and vitality of downtown areas, providing places of employment for central city residents as well as suburbanites. Therefore, continued construction of office buildings is vital.

Over the last twenty years, while employment in manufacturing industries in central cities remained relatively constant, employment in the government and service sectors increased dramatically. Government and service workers are office-space-oriented. Employment growth in the government and service sectors is a major determinant of office building construction. It has also been largely responsible for the total growth of new jobs in central cities.

We project that in the coming years, there will be a continuing increase in employment in these sectors, and that unless adequate new office building construction is started soon, there will be a lack of adequate office space to accommodate these new jobs.

BOMA is concerned that two of the proposals of the Administration--expansion of Section 189 to all taxpayers and the accelerated expiration of all business energy tax credits--are a disincentive to capital investment in the real estate industry which will retard needed construction of both new and replacement office buildings.

Since much office building construction occurs in the downtown areas, incentive given to construction will contribute to the revitalization of our urban cores and work to further some of this nation's important urban and social goals. If current incentives for real estate are repealed or limited, we are concerned that new office building construction proposals may be rejected in favor of competitive investments. This situation takes considerable time to correct itself in the office building industry since the amount of new office space proposed is often just a fraction of the total office space market with only a modest influence on the market rents for office space services. Eventually, of course, rents will rise high enough to favor office building investment, but in the intervening period cities will lose tax revenue and may need to reduce some vital municipal services. The members of the service-dependent urban population will pay part of the cost of these problems.

III. ADMINISTRATION'S TAX PROPOSALS

A. Construction Period Interest and Taxes

Section 189 of the Internal Revenue Code requires that a taxpayer other than a corporation (which is not a subchapter S corporation or a personal holding company) capitalize real property construction period interest and taxes over a 10-year amortization period. Because the 10-year period was phased in and did not become fully effective for commercial and industrial property until 1982, the full negative effect of this provision has not yet been seen by the real estate industry.

The effect of Section 189 is to drain capital from the real estate industry by denying individuals the right to deduct currently actual, out-of-pocket expenses as others are allowed to do. This inequitable treatment discourages investors from the development of real estate.

In addition, the additional capital required as a result of Section 189 increases the cost of development and forces either the rents to lessees or the prices to purchasers to rise.

Section 189 is particularly onerous today when interest rates are so high. It discourages entrepreneurs from entering into otherwise viable office building and other real estate developments or construction which reduces competition and increases prices.

Repeal of Section 189 will merely allow a dollar-for-dollar deduction of amounts actually paid as interest and taxes during the construction period. This will equalize the treatment of interest and taxes between real property business expenses and all other business expenses. Moreover, repeal will eliminate the current anomaly in the law which treats the income from real property investments as business income but denies expense treatment to the costs which generate that income.

The Administration has proposed extending this investment disincentive to all corporate taxpayers. In light of the adverse consequences discussed above, we support the total repeal of the provision in order to equalize the treatment of interest and taxes between the real estate industry and other business endeavors, remove the current discrimination between individuals and corporations, and, finally, encourage investment in productive real property.

B. Business Energy Property Tax Credits

Section 46 of the Internal Revenue Code, enacted by the Energy Tax Act of 1978 and modified by the Crude Oil Windfall Profits Tax Act of 1980, provides additional tax credits of 10% and 15% for investment in certain types of energy property. The majority of such are scheduled to expire on December 31, 1982, but several of the credits are scheduled to expire on December 31, 1985.

C. Energy Conservation

Energy conservation remains a major and essential national goal which cannot be met if energy conservation incentives are eliminated. Such incentives are necessary to correct past investment disincentives such as price and allocation controls and unfavorable tax policies.

Commercial buildings and facilities, including office buildings need expanded rather than contracted energy tax credits. The IRS has ruled that specially defined energy property such as automatic energy control systems is ineligible for the credit when installed in retail or office space, despite the facts that such systems produce major energy savings by substantially increasing the efficiency of heating and cooling equipment and that a large percentage of the nation's energy is consumed in commercial and office space.

Unfortunately, the Administration has proposed to repeal the credit for all energy property on December 31, 1982. BOMA urges Congress to reject this proposal and extend--and expand--the business energy credits to maintain the progress toward conservation which has already occurred. In addition, BOMA urges the Congress to make clear that systems such as automatic energy controls which produce major energy savings are eligible for the credits when installed in office buildings. BOMA suggests that these changes would significantly improve the likelihood of achieving the national goal of energy independence. S. 1288, the Commercial Business Energy Tax Credit Act, which is now pending in this Committee, would accomplish these objectives. BOMA urges that the provisions of this bill be enacted.

Mark Vayda (703)734-1986
Political Economic Market
INTERNATIONAL CONSULTING
P.O. Box 3265, McLean, Virginia
22103

Would you be interested in a simple, equitable way to balance the U.S. budget? Just a small, four(4%)percent "Investment Stimulus Fee"[1] of the type proposed by the attachment, payable in twelve monthly installments, (fully refundable as an income tax-credit at year-end) would transform the present budget from a projected $100(plus)billion defecit into a possible surplus[2] for fiscal 1983 and symulteneously launch the biggest non-inflationary manufacturing and construction (including housing) boom in United States History!!

This is a straight-forward proposal resolving the differences between the administration and various intra- and inter-party adversaries. The program will give each of them what they say they are seeking:

- The White House: Tax Cuts Untouched; No Increase in Income Tax; No Cuts in xyz programs, Especially Defense
- Congressional Moderates, and Liberals: No Curtailment in Social Programs; Trim the Budget Defecit
- Congressional Conservatives: Balance the Budget; No Cuts in Defense

Obviously, this program is predicated on obtaining more revenues thru a non-inflationary, equitable, palatable manner ... AND providing a bonus of a non-inflationary BOOM beginning almost immediately! ... culminating in a permanently full employment private enterprise economy in less than two years!! AND ... provide a means of eliminating the Income Tax in approximately five years!!

CAN ANY CONSCIENTIOUS POLITICIAN REFUSE TO EXAMINE AND CONSIDER SUCH A PROGRAM?

The attached write-up is extracted from "A Genuine Third Position" political-economic concept that I have been evolving for more than twenty years. I believe the stimulus "fee" and the equally basic tax substitution described in the attached will not only be useful to the present budget process, but are essential in bringing about a concensus among political adversaries, and make possible a program welcome by all our citizens!!

(con"t page 2)

(See Footnotes and Defintions pages 26-30)

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[1] Not a form of Tax on Sales or Earned Income, yet totally consistent withour traditions.
[2] The possibility of a surplus exits for the very first year!

If this proposition is of interest to you, I am here and willing to help anyone with the dedication to follow through. I shall also welcome your comments, regardless of your level of commitment to the program succinctly explained in the attached. I am ready to answer questions, discuss, testify, lecture or whatever on matters related to this non-inflationary, non-punitive solution to our tax problem, so tied to the origins of this wonderful country.

Sincerely,

Mark Vayda

MV:sah

How To Launch
A Permanently Full-Employment, Private Enterprise Economy[3]

[achievable in any free country within two(2)years]

... and, in the case of the U.S.,...

BALANCE THE BUDGET - 1983

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• Note: Except for use by the Congress of the United States in discussion and preparation of the U.S. Budget-1983 and in publications of the Congress, publication of this document and materials attached hereto, in whole or in part, must be with prior approval of the author who retains exclusive rights on this material.

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[3] Extracted from "The 'KNOW WHAT YOU STAND FOR' Letters of Thomas Jefferson II
Authored and published by : Mark Vayda of McLean, Virginia 22103
(P.O. Box 3265)

o Summary

The purpose of this discourse is to establish validity, palatability, and expediency of the simple solution to the budget and re-industrialization. Both the solution and underlying concepts are applicable to the economic problems facing all private economy countries today. It is further anticipated that the incontestable success that follows will diffuse the competitive hate of private enterprise,& the US, now portraying actual, and imagined, inequities of our system. With today's communications it would not be long before competitors in power would find themselves compelled to imitate our exponentially more successful example ... including the greater-than-ever freedoms it would involve.

Without the fundamental enhancements and high level success that I see so easily within our reach, I sense that we are in great jeopardy. Despite their fundamentally faulted systems, socialist/communist countries have far outdistanced us in hard product growth(ultimately affecting living standards and national security)during the past decade. Their hate-inspired, unethical, revolutionary rhetoric alone, at a time when our economics have been less than satisfactory, provides enormous fuel for troublemaking at home and abroad. ... so, we much need a simple cure consistent with our original values that I shall suggest. ... but you are interested in balancing the U.S. Budget-1983. Well, you might be surprised to find that these seemingly complex problems come in one very simple solution. Let us go on to my observations and resulting solution:

1. "The Poorer the Country, the Higher the Price of Land",... and...
2. The governments of countries with the highest priced lands attempt to collect the smallest percentage of their total tax levy from the land. (It can be assumed that a land tax will discourage an owner from holding a property if his yield,especially from 'unimproved appreciation' would b negative after paying a land tax. Such a tax would have a tendency to hold down the price of land - especially raw land, would it not?)
3. I am convinced that land prices have an exponential effect on the rate of overall development (elaborated within) determining the rate of industrialization, new product, jobs,competition, etc., with their ultimate effect on prices & standards-of-living. In fact, I contend if the market for land were sufficiently competitive, something approaching perfect competition could exist within the country, at which point, and only at which point, capitalism becomes a beautiful thing for all the people. However, every dollar of investment oriented toward "unimproved appreciation"[6] results in a multiple of that amount withheld from investment in production, jobs etc., and the resulting benefits described above.
4. It is generally acknowledged that sales and income taxes have very adverse effects on the working poor. What is not generally understood, is that sales&income taxes act to increase the spread between the rich and the poor ... yes, I am saying that they make the rich,richer, and the poor,poorer. This for several reasons: 1st: For every dollar of these taxes collected and spent, the taxpayer is one dollar poorer and everything that he buys will be more expensive; that is called inflation. During inflation, the owner of land and property is the main gainer, as these elements inflate faster than anything else; 3rd there is a factor that I call "control inflation". These and other important reasons are explained in this discourse.
5. If you have followed with me this far, what I propose will seem quite natural and obvious: The US was the only country founded with a land tax the only legal tax on its citizens. Just a four(4%) avg. land rental income "Investment Stimulus Fee", refundable as a credit against income tax at year end, will produce a minimum of an additional $125 billion the first year while launching the biggest, most efficeint economy in all time! Are you interested? Well, then, please read on, and be sure to get back to me with any and all of your questions.

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[6] See 6/11 page 28: footnotes and definitions

• Introduction: "Two Wrongs Don't Make a Right", or, "Shame on Both CONSERVATIVES and LIBERALS"

Belieing the title, I believe that Americans, with the rarest of exceptions, along with our very busy political professionals, are well-intentioned. To me the launching of the world's first successful democracy was the zenith of man's philosophical achievement to date, as was the capitalistic economic miracle that followed, so inextracably tied to the free man, the free vote, and the right to acquire and hold private property, over any and all others.

Of course, like any concept so revolutionary, there were some missing links - of which some have become almost full-time occupations for us today. Perhaps the most important of these was and still is the development of a (capitalistic, individualistic) solution for bringing all those who are able into the productive-consumptive process, and providing adequately for those who, for no fault of their own, can never be a part of this process.

By now you and I have become the victims of our more recently arrived [multi-millions] of European ancestors, bringing with them the thinking, remedies, and resulting centralist, socialist systems which were the root cause of the stifling, fixed hierarchy of man-over-man, and the limited individual opportunity, that they supposedly fled Europe to escape.

The resulting collage of an economic system I suppose we would call "Welfare-State-America". It now has grevious problems, in many respects greater than at the founding of the young republic. Firstly, most of us would admit that the approaches taken to resolve the problems of the 'needy' to date, have only served to weaken the efficiency of capitalistic enterprise. 2ndly, the process attempting to "take from the rich to give to the poor" is totally alien to the original concept of freedom in the United States. Thirdly, it has not worked ... it has not resolved the problem for those at the bottom of the economic latter. The spread between rich and poor today is greater than when these programs began to receive major support (i.e., 1932) and the percent of people below the poverty line is bigger than ever (following fifty years during which the size of government has increased 10,000 percent!! [Do you know ANY other statistic that even came close to growing that much in the last fifty years?[4]].. Pernaps it is time for a cost-benefit analysis.)

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[4] Yes, but to my knowledge there is only one other economic statistic that has equalled and surpassed the growth of government: The increase of values in land and property in situations of close "Control Appreciation", in many cases exceeding twenty thousand (20,000%) percent during the same period!!! (See footnotes, pages 26-30)

Let us, for a moment, reflect on what I call "The Natural Order of Economics(&profit)From the moment you are born and take your first nurishment, you are a consumer ... and you never quit until the day you die. Consumption would then be your number one priority. Your second level of action is creative, or entrepreneurial, witness the externally-internally oriented child making his first creative marks on a piece of paper.... While that creative entreprenuerial activity is generally intermittant, it remains the avenue through which man contributes most to himself and to his fellow man, and thus should remain in second place. The third level, through which most of us must pass, is securing and carrying out a job in search of a livlihood, as a worker in the service of a more successful entrepreneur. of course, the fourth and final level of involvement comes from our "surplus"[2] time and funds, commiting our energies to help others(utilizing the knowledge we have extracted from a the experience of our lives) mostly given thru private and public institutions.

Would it not seem natural then, that our elected representatives should follow a similar order of priorities in their efforts to protect the interests of the citizen? Does this mean that I am suggesting that we should be fed, housed and clothed by the State? ... by no means! But it does mean that, without the express permission of the voter, nothing should be done to interfere with the bringing of more,better and less expensive goods, more accessible to the market place, and to the consumer. In its crudest form, capitalism supposedly achieves these objectives (and very well it might if it were not for a "missing link" required to cope with a concept of paramount importance,having a major negative effect on all economies, which I call "Maximum Discomfort Level"[5]).

As long as a "system" were to provide all the welfare-state benefits, wouldn't even the socialistically inclined welcome the chance to "stimulate" capitalistic enterprise to fulfil its function better than ever:bringing greater abundance, more variety, more economical, and higher quality goods and services to market than any other system ever has or ever could provide the consumer? Well, that is exactly what the "Investment Stimulus Fee" system purports, and WILL DO!

However, there just may be one group who would be less than enthusiastic about the new "Fee" because it would make more work for this group of 'capital-holders'(I did not say entrepreneurs) in a comfortable form of conservatism align themselves almost religiously with aggressive liberals pressing re-distributive measures "designed"to remedy the problems of those at the bottom of the economic latter . It is impossible to know whether either of these groups fully recognize that these re-distributive measures have to create inflationary effects leaving the poor, poorer than before[4] and those"conservatives" (supposed targets of re-distribution) the beneficiaries with non-productive assets increasing in value[6] at a rate far exceeding taxes imposed, or any effect of inflation on their other activities.

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[5] See Definitions page 27.

Am I here suggesting another "robinhood" scheme under a different guise? Far from it! The rich having the capital doesn't do anybody any harm. What is harmful, in my moralistic, socio-economic judgment, is the flow of major investors toward the more "underdeveloped"[7], so-called 'conservative' investments. Worse than non-productive, these act to restrain productive investment, and for so doing, attain a yield far higher than the productive entrepreneur. This has a major negative effect on the economy, as explained within the following proposal.[8]

So, in summary, we note that neither the actions of the Liberal or the Conservative do anything in the way of increasing competitive, innovative production. The actions of neither of these political groups assist in the production of more, better, less expensive, or more varieties of goods. To the contrary, as the attached will adequately demonstrate, the actions of both add to the costs of all consumers, and benefit only the holders of"underdeveloped capital"[7] and those who have the 'good fortune' to have a portion of the "public trust" under their direct control.

What is 'missing' then, is an effective "stimulus" to the large holder of undereveloped capital encouraging him to either assist the innovative producer, or compete with him, in accelerating the development of improved products, and/or intensifying the level of competition, to the benefit of the consumer. It is important that the largest holders of underdeveloped capital be "stimulated" to particapate in this constructive process.

We have often heard of the phenomenon of "over-production". Until every man, woman, and child in the entire world have sufficient food clothing, housing, and transportation, there can be no such thing as 'over-production'. Then what we really experience periodically, and even on a continuim, is a vast problem of under-production, under-utilization of resources, (including human capital) and under-distribution of finished product ... that "stimulated" capitalism can accomplish faster, cheaper, and better than any other system. Along with the concept of 'over-production' is usually mentioned the even more widely-held misconception: The"inevitability of business cycles".[9] If we ever get the theme of this proposal off the ground, I shall be happy to convincingly demonstrate

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[4,6,7,8,9] See Footnotes and Definitions, pages 26-30.

that 'business-cycles' need not be inevitable!

Certainly, after balancing the budget, attaining full employment, and continually lower levels of prices, there will remain other major social and economic problems for resolution. However, in addition to solving the former, as this proposal promises to do, it is also my not-too-modest aspiration for this proposal to introduce our legislators to a new method of analyzing cost-benefit-ratios, teaching them no net gain can be achieved in attempting to resolve a problem in a way that involves taking from the "motor-power" in (i.e., taxing the income) of the nation!!

What I am, in effect suggesting then, is that we begin to seek "capitalistic answers to capitalistic problems" rather than continue to attempt to solve capitalistic problems with "socialistic" answers. That futile course is like our old saying of "mixing oil and water ... they just won't mix". All it can do is render capitalism ever more ineffective until it eventually succombs to a much less efficient and personally less satisfying "militant socialism". I hope there are not many seeking a socialist solution, but, without changing course, if you doubt it will happen, I am willing to wager you that I can prove it will, to any human being willing to reason with me. All my money is also available to the thinking person who I cannot convince that socialism ultimately has to lead to a loss of individual rights and liberties, preserving no vestages of genuine individual democracy. ... Just try me!!

Americans must become idealogical! What is our idealogy? Free elections, a free man, free association and the sacredness of private property. This all we have to sell, and indeed, sell it, we must. The resultant dictatorships of all other elitist, centralist states, will not relent in their efforts to destroy any vestage of democracy, against which an informed free man will never knowingly select. Our continuing interferance with the election in El Salvador, in support of an elitist dictatorial land and bank nationalization, will require quite some time for L.A. supporters of USA and freedom to forgive &forget!

So where does all of this leave us? Simply with the task of purifying and humanizing the beautiful old concept of "Free Enterprise" in a way that will add to its efficiency rather than subtract from it. It is just plain amazing to me that, with all that has been written about the private enterprise system, that no one has ever attempted to "work with it" , that is to say "enhance" it. It reminds me of the socialist concept of human nature which they treat as bsically flawed, requirin force to overcome, instead of finding a way to work with and use man's basic nature for his and everyone else's benefit. The same goes for capitalism. We must learn to work with it and maximize its usefulness to man, and yes, even improve its efficiency ... but that would require understanding its full nature, in which understanding, I am afraid, as a nation we are sadly lacking.

The capitalistic answer which I promise in this proposal involves an "Investment Stimulus Fee" which will supply the funds needed to continue the present level of "social benefits" for as long as needed or desired However, the "Stimulus" eliminates the need for many of those social benefit programs, and in the process, the use of the "Investment Stimulus Fee" should teach an entirely new way of resolving future social and economic problems.

It is an approach that faults current positions of both major political positions yet gives each what they say they are seeking:

- Conservatives: No more tax on Productive Income;
  An opportunity of more businesses to be more successful
- Liberals: Ample funding for Social Programs oriented toward
  those at the bottom rung of the economic latter.

o ...(and I know that the worker-consumer and the productive-entrepreneur would jump through hoops in order to have this program enacted)

I began this Introduction stating my belief in the good intentions of my fellow Americans and our politicians. Because of that faith I am taking time to bring a new, and far-reachingly effective solution to your attention. The solution, concepts on which it is based and observations from which these concepts were synthesized, are the result of spending thirty years as an international market analyst, with the necessary attention to political-economic factors. I have been fortunate enough to be able to view economics from a perspective that few have been able to share. Those with whom I have spoken have urged me to do so now, and it is in this context that I am contacting you.

Assuming that you find the concepts and resulting solution as comfortable as I do, where do we go from here? First, I look forward to hearing your reactions; answer any questions you may have, and offer you supplemental data, such as a comparison of economic costs and yields of the various re-industrialization incentives, including the "Investment Stimulus Fee", the tool recommended here for balancing the budget.

"HOW TO BALANCE THE US-1983 BUDGET IN A WAY PLEASING TO ALL, AND CREATE A Permanently Full Employment, Private Enterprise Economy

[achievable in any country within two (2) years]"

by Mark Vayda © copyright 1982

Here is a simple explanation of how to create an economy of unparalleled material and spiritual success anywhere[12] (ranging from the U.S. to El Salvador to the Zimbabwean Republic. The first country to implement this system of stimulated private enterprise will create, for the first time in history, a permanent excess of demand (by employers) for the services of labor, with all the benefits for labor, and the economy, that this implies. The result is a nation where, stimulated to divert their wealth to more productive enterptise, the rich gain wealth faster than ever before ... yet in creating new product and wealth, circumstances are created wherein the poor's disposible income improves even faster ... the income distribution "gap" between the well-to-do and the working poor begins to close. (Both rich and poor will benefit most markedly in the poorer third world nations choosing to implement the plan.)

This plan will place any nation[12] on a course satisfying to all its citizens within a month or two, and result in full employment and optimized economic conditions on a permanent basis within two (2) years! Quite a promise for two short years ... or any length of time, isn't it? Some of the more striking of these optimized conditions include:[13]

1. At least one productive employment opportunity for every person seeking to work.
2. An immediate and increasing budget surplus (with ever lower punitive taxes on investor-producers, workers and consumers).
3. Lower, non-inflationary prices, higher "real" profits, and ~~the~~ much low~~est~~ lower interest rates ~~in recorded history~~ (moving toward 2%).

Depending on other vital but even simpler to implement enhancements, these additional benefits are possible:

4. No more nation-wide recessions or business cycles ... ever again!
5. A consistent balance of trade and a stable, highly valued currency.
6. A greater level of freedom for the individual and the corporation.
7. (Of course, all of the above would tend to increase individual, national and international security, creating a climate for growth of individual and national self-worth, at rates of advancement unthinkable in this world of ours today.

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[12] See Footnote summary pages 26-30.

[13] For mor complete list of advantages see pages 19-20.

- Relationship of Land Prices to Economic Progress - World-wide:

Let us now begin by considering a very important axiom of mine, not generally recognized and therefore the implications of which have here-to-fore not been adequately examined:

"The Poorer a Country Be, the Higher the Price of the Land!"[14]

Amazing, isn't it? ... But true! (There are some exceptions but their circumstances only further reinforce my conclusions and suggeted solutions.) This anomaly has profound negative effects on the U. S. economy, as well as that of every other nation in the so-called "free-world". It is a primary "disincentive for investment in development". It is obvious that a high land price is a major deterrent[15] in attracting productive investment to a developing country. Just as obviously, land prices can be a determining factor for new industry selecting among otherwise comparable sites in highly developed nations. Even when nations start at the same general level of development, their differing "policies" vary the speed of development. Just which policies? ...and why? The nation that stimulates the most intensive use of resources (i.e., land, minerals, existing plant--plus uncommitted financial and human capital and, of course, attracts foreign investment) registers the biggest increases in GNP, net worth, and, we are told, provides the greatest level of improvement for all its citizens. Without interaction of the land, nothing happens.

Why then do not land-owners and development commissions in the poorer nations attempt to make their land-holdings attractive to the world financial markets? Answer: These poorer nations with the high priced land are generally the same ones experiencing the highest rates of inflation. The large land-owner participates generously in inflation by a phenomena I call "control appreciation[8]," and therefore has little incentive to make accommodations to foreign buyers. Development commissions often operate on the thesis that high land prices help to assure an adequate participation for their "native (land) investor" in joint ventures with foreign investors. (On another occasion I shall be pleased to suggest other more effective, and equitable, means to raise investors in the poorer countries to a level competitive with those from the investor countries.)

[15] Of course their are other deterrents to development. Those not covered here can be analyzed for you at a later date.

[14] ... And the lower the percentage of government revenues that come from the land.

Comparative Evolution of Taxes in the United States and Other Countries:

Do you know which country (until recently) had the lowest land prices (for comparable use) among all countries where land is a freely traded commodity? Yes, it was the United States where traditionally a larger portion of government revenues came from real estate than any other country. A land tax stimulates owners to follow the age-old real estate maxim, "Best and Highest Use," or sell the property to someone who will. Did you know that for the first ninety years of U.S. History (from the Boston Tea Party until Lincoln introduced a sales tax to pay for the Civil War) the land tax was the only legal levy on the U.S. citizen? Here is an example of how it worked: By the time he became President, George Washington was a very wealthy man. He owned 9,000 acres of first class farms on the Potomac and 30-40,000 acres in Kentucky. However, his less productive heirs lost the land by the time of the Civil War because they could not pay the land tax![16] The new buyers had to be convinced that they could make the land pay off (to do so requires new investment, resulting in more jobs, increased competition, lower prices and an **improved living standard for everyone**) In contrast, General de Velasco was awarded one-third of Cuba for defending Havana against the English in 1654. When Castro took over in Cuba in 1959, de Velasco's heirs still owned most of that land, including a still undeveloped parcel, bigger than, and directly across the bay from, the 2 million population of Havana (enjoying a price infinitely higher than comparable land in the USA)

All de Velasco's heirs[16], like those I knew, may have all been upstanding, hard-working people. Nevertheless, these heirs had to reach what I call "the maximum discomfort level[5]" in effort required to tend their lands, cattle, employees, etc., (at which point, for inability to make more intensive use of resources, a land-owner should be "stimulated" to sell his lesser-used property to the resourceful individuals, who in effect are offering to commit additional resources to seek "best and highest use" for the land). However, land taxes were non-existent to inconsequential in Cuba[17]. The U.S., has reversed its tax base from 1932 to present (Now only 20% of government revenues are land-related. The other 80% of the present tax base will be analyzed further on), and so the U.S. presently encourages an orientation toward "control appreciation[8]," and all the problems that it creates.

The same principles apply whether talking about the rural countryside or the slums of the inner-city. Slums generally develop on the periphery of the most expensive and highest use real estate. However, whether present owners be residing in the slum or not, searching for "best and highest use" is not how they will realize a profit. Because annual "unimproved appreciation[11]" far exceeds carrying costs in slum/ high-use real estate (without applying the new concept of the "investment stimulus fee")[1], owners will continue to restrain "active" productive investment[6&20] until their financial concerns, generally unrelated to the property in question, "stimulate" present owners to relinquish control.

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[5] Understanding the definition of the concept of "maximum discomfort level" has major importance to understanding the"Fee" theory. Please read definition(pages 26, 27.)

- The Negative Aspects of "Unimproved" and "Control Appreciation":

Productive Capitalists attempt to earn a living, offering us a competing selection of new or improved products and services ... At whose cost and risk? Only that of these creative risk-takers themselves. ... And for whose benefit ? ... Amazingly, largely those who buy (whether you buy a new product offering or that of an established competitor, the competition will have a positive effect on the quality, price, service, or all three).

"Control Appreciation" frustrates or stifles the innovative and resourceful, raising the costs of introducing their inventive products and services to the market. Apart from the obvious effect of control appreciation on land prices and interest rates, other negative effects include: LOSS OF: 1) productive investment, 2) product improvements, 3) wages, and 4) living standards (not achieved)... AND prices continue to rise (only with intermittant recessionary relief).

The "Control Speculator" profits by delaying, or denying willing buyers access to his underdeveloped real estate investments. [Let us compare him to the productive risk-taker.] If the control speculator loses, who bears the cost? John Q. Public--always! [[If the loss occurs in good times, the control speculator has already retarded the sale and caused some inflation. If the loss occurs in bad times[9], only another speculator would 1) be in a position to, and 2) wants to, buy.]]

Now, ... what happens if the control speculator is successful? Only he is successful ... there are no fringe benefits for any part of society ... nothing becomes better, or less expensive. (Incidentally, the control speculator generally has the staying power to be successful.) What we are saying is that the control speculator's "risk," in a long-term inflationary, primary seller's market, is one of holding an asset (almost always increasing in market value), anticipating actions by others[18] which may "up-grade" or intensify the market accelerating the rate of "unimproved appreciation" during the period that the "control speculator's" investment is obstructing investment in productive improvement by others, and contributing to the cost of everything that we buy.

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[9] With the Implementation of the "Investment Stimulus Fee", it is possible to diminish the significance of business cycles. More complete explanation under "Definitions pp26-28.

- Impact of Unimproved Appreciation on Present U.S. Economic Squeeze:

In the period (1932-82) when the U.S. reversed from a "land stimulus" to a "tax-grab-from-income," everything from cars to coffee has risen in price from one thousand to three thousand percent (1000%-3000%)--an average of fifty (50%) per year... And that will get much worse... as interest rates drop, pressures of two years' limited housing starts, and persons "trading-up" with a similar fixed mortgage payments will rachet housing's percentage take of the individual's net income up still another notch. (Strange, isn't it, that the U.S., originator of a rudimentary land stimulus, would evolve to tax laws now reserving the highest level of rewards for those investing in "control appreciation" and obstructing the innovative risk-taker in his efforts to bring more economical, and improved, products and services to the market??!!)

Historically too little attention has been given to distinguishing between Productive Capitalism and Control Speculation[19]. Economists, inclined toward both the left and the right, have generally accepted "Land Speculation as an inseparable part of Productive Capitalism" (Wrong!!) But, by now I expect you can visualize how a proper form of "land tax stimulus" would render "Land Speculation" and "Productive Capitalism[20]" as very separate and distinct activities and easily isolated from each other. You have seen how "Control Speculation" counteracts the economics of Productive Capitalism that would bring prices down and quality up. It also thwarts major portions of the populus from entering the productive-consumptive sector to gain a their self-respecting share of the "fruits of production".

Without spending even one, red cent of taxpayer money, the "Investment Stimulus Fee" of this proposal creates an incentive to invest, in new and more productive assets, and improve productivity of existing assets ... OR... to sell to someone who will. The "ISF" is not intended for, nor does it result in, re-distribution of wealth. Its sole purpose is to stimulate existing capital sources (especially those currently involved in "Control Appreciation") to, directly or indirectly, invest in new or improved plant and product, from which, as we have already shown, the worker-consumer has to be the ultimate beneficiary.

Now you can appreciate why I say that:(differing from all other taxes):The "Investment Stimulus Fee" is the ONLY source of government revenue that CAN BE THROWN INTO THE OCEAN after collecting it, and that everyone, including the majority of land-owner-taxpayers, is better off financially than before the "Investment Stimulus Fee" was implemented.... Thus, I call it the ONLY tax for the advancement of a healthy and competitive capitalism (... for a healthy and wealthy economy and populus.)

It is not proveable whether the founding fathers of the United States fully appreciated the soundness of the structure they were launching with their land tax. It was the first and only example of men volunteering to tax their own land and avoiding all forms of tax on income of any sort. It probably was more out of compassion for those not yet having land,combined with their awareness of how the "evils" of "income related taxes" (i.e., sales and income) had worked in their own disinterest, that they selected the land tax on themselves as the only remaining alternative. HOWEVER, not only did their land tax move in a limited but positive way to emphasize productive investment over "control appreciation", but it helped them to avoid the very negative, or what the may have considered " evils" of income related, re-distributive taxation. (These taxes form the second negative force leading to the absolute necessity of implementing an "Investment Stimulus Fee"!!)

• The Compound Negative Effects of Sales and Income Taxes on Everyone

Are you aware of the fact that "For every dollar of SALES and INCOME TAX you pay, not only do you have less dollars with which to purchase your needs, but everything you buy will cost more by a multiple factor of the amount of tax you pay?!?

Does that sound strange??!! Well, it is just as true as the axiom about the price of land (i.e.,"the poorer the country, the higher the price of land")!...and the combined effect of both of these axioms on all of us, the John Q. Publics of this world, is absolutely disasterous! If we had the benefit of a land stimulus fee in existence during my lifetime, the average of us would only need to work two (2) hours per day by now, to live at a far increased standard of living instead of the now increasing burden on our large and ineffective service worker component and ever lower commitment to productivity and production. In the United States the effect has been to eliminate hard industry to the extent that only thirty(30%)percent of the work force is employed in productive activity. No nation in such condition can consider itself a world power, and secure against long run threats of force without further destroying the economy.

Now, for contrast, let us take a minute to simply demonstrate some important negative effects of Sales and Income taxes for any consumer willing-to-be-worker-producer within a society:

Let us suppose that you are a shirtmaker and I, a shoemaker. Let us say that I decide to quit making shoes and go to work for the government instead. My reasons are unimportant. I may be seeking higher pay, job security, fringe benefits such as vacation and/or retirement, or to train new shoemakers...or whatever. In any case, you have to pay a fraction more taxes to cover my new government wages. Let us say we are a small island nation and that your share of my new wage comes to an additional dollar ($1.00) in tax.

Here are some negative effects on your money supply, and the cost of what you buy:

1. Obviously, you have one less dollar (-$1) available to buy your next pair of shoes. -$1
2. I no longer make my own shoes, but still consume, so now I represent one additional consumer of shoes (causing a shortage of shoes and a pressure toward a higher price for shoes. (+$ cost)
3. I no longer make your shoes (or anyone else's) so, still less shoes are available for purchase, and those that are undoubtedly will cost you more. (+$ cost)
4. ...and we still have not done a thing in the way of helping train new shoemakers. (one more $1 please) -$1
5. ... nor have we given shoes to underprivileged... or whatever other supposed redistributive benefit the government had in mind for my employment in the first place. (Again, one more $1 please) -$1
6. The cost of production of your shirts, other shirtmakers and shoemakers, and other producers in society has increased because of taxes eventually to a point where other shoemakers, some shirtmakers, and even you may be forced to desert your field[14] as a shirtmaker, resulting in more government workers and/or welfare recipients bidding on an evermore limited and costly supply of shoes. -$2 (+$ cost)
7. Now the higher prices of domestic product invites foreign competition on the remaining shirtmakers and shoemakers, bringing about still another cost to you caused by an imbalance-of-trade and the subsequent "devaluation-of-currency" inflation. (+$ cost)
8. Those in power, attempting to show sensitivity to the worker (but lacking an understanding of product marketing economics) suggest wage increases to offset the accumulated inflation, depleting further corporate competitiveness and the possibilities of guiding capital toward productive investment. The result is a continual degradation of national product quality and net production and the collapse of still more productive enterprise, as industry becomes less and less able to absorb and/or pass-on increased costs... and costs will rise faster than ever. (+$ cost)

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[14] See Footnotes page 30.

• Summary of Some Major Negative Effects of Sales & Income Taxes

Now we have seen how each additional dollar ($1) of redistributive taxation, and my new government employment, decrease the dollars you have available (e.g., -$6) and increase the cost of everything you buy by a compound factor including at least the eight (+8$) cost/items that we have listed above. There are others; however, the above are sufficient to demonstrate that, not only is there "no free lunch," but that under the system of taxing sales and income, costs to both the provider and the recipient are so high that both have lost more through the future ineffectiveness of the entire economy, than the well-intentioned gift was meant to cost or provide. If the "market economics" exercise just discussed is not especially clear to you, I expect that you none-the-less appreciate how the "Investment Stimulus Fee", by activating as economy through collection alone, has some special advantages over sales and taxes, which must be spent to achieve their (questionable) benefits.

• How to Implement an "Investment (Land) Stimulus Fee"

We have just seen how two extremely negative economic forces combine to dry up inventive, productive investment while causing all other forms of havac on the existing economy. You might now like to see how the "Investment Stimulus Fee" works in the process of developing a positive economy, in which neither of those negative forces can ever again have significant impact:

Assign a small percentage of the 'average usage rental income' from every unit (i.e., square foot) of land of the nation[2] "Average" meaning that no one pays a "fee" rate based on his own specific holdings but rather on the average rental yield of the entire zone. "Usage" meaning the rental income assigned to an owner-occupied site would equal the rental income of one occupied by a lessee. "Rental Income" referring to the rent, or appropriate proportional income, distributed over every unit (i.e., square foot of land) assigned only to the active asset . The resultant "fee," of course, applies uniformly to all properties within the "zone," regardless of variations in level of development, present value, profitability or activity. "Zones" would be defined as adjoining lands of generally similar "categorization." "Categorization" may generally follow present zoning codes.

A change would occur in the percentage rate of the "fee" only when the selling price of property within the zone increased by more than the sum of the following:

a. The average (over all lands within the zone) of the interest cost for carrying unimproved lands only. geometrically accelerated rates of capital generation that result from an increasingly active, efficient productive plant, drive interest rates down to as low as two percent (2%).)

b. The actual improvements, or capitalization of increases in rental income (whichever is greater) for each property, totalled (for all properties within the zone)

• Definition of "Unimproved Appreciation[11]"

The Selling Price [less the sum of the Purchase Price and (a)+(b)] equals what I term "unimproved appreciation." By increasing the "investment stimulus fee" rate to offset unimproved appreciation, the "fee" continues to divert "control appreciation" into productive investment. "Control appreciation" is the result of "passive" ownership, or investment in improved, or unimproved, land with or without the "purpose" of obtaining primary profit from delaying "active", productive investment or development.

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[2] Payable in monthly installments.

[11] Above definition of Unimproved Appreciation(cross reference page

- Application of "Fee" to Individual Homeowner

For example, let us take a home-owner who represents the "average" in his "zone": A house valued at $100,000, located on a 10,000s.f. lot, with an alternative rental value of $10,000 per year. [Let us say his present taxable income is $30,000 per annum.] Let us assume that the "zone" does not contain commercial, or industrial property not does it contain any undeveloped land. Let us confirm that the home-owner's house and lot are truly representative of averaging the income per square foot, for all the land within the "zone". An annual four(4%)percent "Investment Stimulus Fee" would result in the home-owner paying an additional $400. per year (i.e., $33.33 per month) as his assessment. If the "fee" is set sufficiently high to limit "Unimproved Appreciation" to zero, like all other land-owners, the home-owner would be entitled to an income tax credit, to return up to One hundred(100%)percent of his "fee" from the national treasury "surplus" for that year.

- New Federal Revenues resulting from the Implementation of the "Fee".

The implementation of a four(4%)percent "fee" could generate well in excess of the following revenues for the U.S. Budget 1983. Here's how:

a) With thirty(30)million homes with a weighted average value of $100,000 and a rental of $10,000 (same as example above) the residential sector would supply $12 billion in new revenues from the "fee". It is estimated that the commercial and industrial sectors would represent $20 billion and $18 billion, respectively. Sub-total ... $50 billion

b) The "stimulated" economy (without considering the savings in revenues from fuller employment, less welfare, etc.) additional revenues from already established taxes would produce a very minimum of another $50 billion. Sub-total ... $100 billion.

c) Assuming a national policy commitment to gradually reduce "unimproved appreciation" to zero, during the early years new productive investment would be attracted into the economy at a level approximating the following formula: (100 ÷ the going interest-rate for every dollar of "fee" collected) ; i.e., $50 billion x 100 ÷ 20 = $250 billion new investment. Applying a ten(10%)percent tax yield from established tax sources for the first year, new investment would yield an additional $25 billion. ISF induced revenue Grand Total ... $125 billion.[22]

Predicting economic behavior, even with sound concepts is, at best, an imprecise science. However, anyone familiar with the statistics employed here will concur with their overly conservative composition.

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[22] There are other non-redistributive revenues measures also now needed which would further assist re-industrialization. Shall discuss on request.

• WARNING!! Dangers of NOT Implementing"Investment Stimulus Fee"

If the US. money supply increases, and interest-rates fall before: The US Budget is brought into balance, and 2) a U.S. international "balance-of-trade" is established, [[and/or 3) before an "Investment Stimulus Fee" is implemented]], applying only conventional wisdom , the following events would seem to be all but inevitable!: A) a major devaluation of the U.S. dollar, and B) a surge of the worst housing inflation in US. history will explode within less than three years. The lower interest rates would then siphon-off into the more secure areas of "control appreciation" (and speculative currencies, and arbitrage) much of the"savings"recently induced by low productivity and high interest rates ... savings that were"supposedly"ear-marked for investment in re-industrialization. Of course, until something is done to change one of the fundamentals that would once again make U.S. product competitive in the international market, (It would seem that the one change, palatable to all, would involve the implementation of the "ISF", around which politicians of all stripes could easily rally.) there can be no re-industrialization that will be fully utilized, make American product more competitive internationally, and not become onerously expensive to long run American industrial viability and, even the consumer.

During this period, the poorer, non-capital-holding members of the population will suffer the most. Of course, their aspirations of owning their own home will become ever more remote (if events are permitted to run their course) as we move into the most rapid boost in housing costs in history!

Under the tax systems now in favor in the world, the poor - especially the working poor, can only expect to become poorer ... and the middle class will not fair much better. Who gains in an inflationary economy?...Primarily those who have the most value to "inflate" (e.g., land , building, factory, farm, mine, lumber, etc.). Their primary gain will not be from competitive production but in the "unimproved appreciation" i.e., higher prices for land a less effic- plant and product occuring at the cost of productive-consumptive society, (which just could not happen with an "Investment Stimulus Fee").

For all Americans, then would it not be more satisfying to start to establish the most efficient fully employed society in history in total keeping with our democratic and personal liberties? A society where the rich become richer than ever directing their capital toward improvements in production, product and service resulting in a rate of improvement in standards of living never before thought possible with the poor who wish to work advancing in wealth and income proportionately even faster!

(beautiful economic and social)

Would not such a condition in the United States do much to deflate that old 'hate-America' set at home and abroad who always seek our week spots,which as our problem has grown, dwells on the 'alienation' and 'second-class' citizen status for our unemployed and working poor. Never mind that these people are cared for better than those much further up the professional and cultural scale in other countries.Yet,inpart, our critics are right... They won't, and we shouldn't excuse a lowering of growth rates, as wellas active productive employment(which eventually hands over, not only higher standards of living to our adversaries,but endangers our very ability to economically and militarily survive in competition with these fundamentally faulted systems!) What I am saying is that we can take no relief in noting and analyzing the faults of "those other tyranies"if we do rothing to philisophically and economically improve our wonderful, old and uncared-for system, "The Workhorse --- Capitalism". If they, by whatever means continue to post "hard-product" GNP increases in excess of our own, it will only be a matter of time before we have fallen behind them in that all important factor called "standard of living",which in the minds of most of the people of this hungry world, is how success is judged, quite irrespective of any consideration of individual freedom and liberty!

(... in addition to advantages named on page #1 of this letter ...)

- Advantages of "ISF" to Citizen: As an Individual; For Business; For Gov't

- Advantages for Operation of Government:

  . Removes need for concern over funding of Federal Budget. A small four(4%)percent "Investment Stimulus Fee", in substitution for income-related taxes generates a revenue "Gross Surplus" (i.e., all the "fees" can be thrown into the ocean and the entire economy would be in better condition than before the "fee" was collected! ... something that no other source of revenue can assure us. The resulting boom economy, evolving toward full employment, can sustain the most extensive programs that would be then attempted by elected representatives interested in the genuine well-being of their electorate. Except for those engaged principally in land speculative activity, the "ISF" would have only positive effects on the income and financial resources of the individual.

  . Removes the need to consider "Inflation" as a cost in making the Federal Budget.

  . The "Investment Stimulus Fee", in the eventual fully employed economy, after attending to the remaining needs of the citizenry and the government, and retiring the national debt, would continue to generate ever larger "surpluses" which should be returned to the citizens by the most democratic process.

  . The"Investment Stimulus Fee" is the first revenue concept in history capable of keeping representative government out of debt. It establishes genuine, permanent cures for the basic economic problems plaguing the entire world, on which approach a new concensus should emerge. As long as "Unimproved appreciation" stays above zero, The higher the "Stimulus Fee", the bigger are the revenues of government -from all sources.

  . The "Investment Stimulus Fee" (compared to Sales and Income Taxes) is 1) much easier to initiate, install, administrate, ... and infinitely less costly in compliance to both the private sector and the government; 2) much easier to audit compliance, administration, and effectiveness of results; and 3) because of its structural simplicity, hopefully, will be less subject to 'tinkering'.

  . Formation of Capital: Assuming a commitment to gradually reduce "unimproved appreciation" to zero, initially, the "Fee" itself, would "stimulate" new investment at a rate approximating [100÷ the going interest rate x the total "fees" collected] The continually improving conditions would create and attract capital of unprecedented magnitude, including foreign sources.

- Advantages for Business:

  . Interest rates would gradually drop to historic lows in response the the increasingly competitive market for a geometrically expanding variety of goods and services ... matched by unequalled buying power in a fully employed economy.

  . The larger, more stable, rapidly growing markets (which, with some other matters adjusted, could avoid business cycles) would offer incomparable opportunities for new venture and new product planning.

  . The more competitive environment, especially with the"other matters" referred to above 'resolved', would assure A Balance-of-Trade.

(con't. Advantages for Citizen)

- Advantages for Individual

  - More abundant and more challenging jobs; no more 'make-work' jobs; No more able bodies on Welfare.

  - No futher need for 'cost-of-living increments to meet inflating personal budget requirements.

  - An ever shorter work week would number among the gains achieveable in an environment where employers would compete ever for an ever more productive worker.

  - More after-tax earnings for the worker. (Fees no higher than than sum of previous tax obligations (none for thirty(30%)percent non-owners) until "ISF" replaces all other income related taxes; While it is expected that the "fee will continue to grow, the real "net cost" in terms of what the ownerworker draws from the economy will become increasingly less!

  - Regular and increasing portions of earned income would be productively invested by the worker whose income and living standards ar advancing so rapidly. Worker would have more time to selectively shop and invest, serving both his self-interest and further honing the competition seeking his business.

  - Lower prices, of course, result from the lower rates of inflation, higher productivity, and intensified competition.

  - The (potential) absence of business cycles* would further stimulate the following: More innovative and marginal competitive product entries in the market place; More competitive quality, variety, price and service, and other non-price advantages.

- Miscellaneous Advantages

  - Eventual re-orientation of accounting and audit functions of both government and private sector would contribute much to product improvement and new venture planning, eliminating much of the negative activity now necessary in administering and monitoring more complex re-distributive tax systems presently in place. (I actually see a net gain in the need for accounting-trained personnel.)

  - A more important role for unions, generating interest by those not presently allied with their cause as unions begin directing themselves toward negotiating constructive formulas for retirement and profit participation in a fully employee marketplace instead of having to negotiate in the negative atmosphere of having to protect jobs, wage levels, etc.

  - Healthy attention would then be expected to turn to inadequacies in the treatment of other important interest groups in keeping with what must be described as the "natural order of economic interest":1) first of all we are CONSUMERS; 2) entrepreneurs, INDIVIDUAL STOCK-HOLDERS; 3rd) we are workers, including the non-union worker.

• Typical Questions and Answers

I expect, by now, the "Investment Stimulus Fee" is beginning to sound quite plausable to you. However, a solution that has been left unsolved for so long is suspect to most people. They begin to look for reasons why is unworkable, unfair, or unacceptable to some part of the populus. The following are some of the questions I hear from time to time concerning the "Investment Stimulus Fee." (I shall be pleased to amplify the answers, as well as address any others you might have.)

1. HOW CAN SUFFICIENT REVENUES BE DERIVED FROM A "LAND STIMULUS FEE" TO MEET ALL THE "NEEDS OF GOVERNMENT?"

a) Just to lend perspective in this confused world of ours, half-facetiously, I ask if the questioner is more interested in the "needs of government" than in the needs of the people government supposedly serves?? ...but then more seriously I attempt to address my response to the largest dollar figure the questioner could have in mind. Remember, just collecting the new "stimumus fee" provides an inducement to invest, and results in a major stimulus to the economy, and a treasury surplus. [As long as "unimproved appreciation" exists, the higher the percentage stimulus fee, the greater the revenue collection, as well as the resultant economic base on which the revenues are collected]... I then ask: "Just what percentage of present government services do you believe would be required to properly care for the public sector in a permanently, fully employed economy?" Their answers usually vary from thirty to sixty percent (30-60%) of present requirements. Interestingly enough, the aggregate of the land-owners in most countries at present provide in excess of 85% of their government's revenue from all sources including Income and Sales taxes. Also interesting to note, the largest portion of those revenues are contributed by the modest land and homeowner, middle-income taxpayer. (In some countries this distortion of tax burden against the middle-income taxpayer is further accentuated because of shelter provisions favoring the large land-owner/speculator, i.e., favoring "control appreciation.") To show the availability of revenues from a land tax, I offer the following example. (Of course it isn't an approach I recommend, but I believe it does serve the size of the revenue base obtainable through a land revenue approach.)

b) For just a moment, let us assume that we simply cancel everyone's sales and income tax obligations. Let us further assume that we increase each land-owner's property tax by an amount equal to his previous payments in Sales and Income Taxes ... who would be the loser? ...the land-owner would pay no more tax than before. Of course, he might be inclined to assess future investment decisions somewhat differently. Persons and corporations with large speculative land holdings would be "stimulated" to put more of their resources into productive investment or sell their properties to more aggressive persons who would. Everyone would then begin to derive the positive effects of lower price levels, improved living standards and the consequential peace and tranquility of society as a whole.

2. "IF THE 'LAND STIMULUS FEE' WERE TO REPLACE SALES AND INCOME TAXES EVENTUALLY, WOULDN'T THE ENTIRE 'BURDEN' FOR TAXES EVENTUALLY FALL ENTIRELY ON THE LAND-OWNER?"

Would you say that the land-owner was given a "burden" 1) if his total "net" tax bill was no greater than before, and 2) if his new annual benefits became a multiple of the sum of 1) his "fee" and 2) his after tax and inflation "net" annual unrealized "unimproved appreciation" would you say that the land-owner has taken on an additional burden? The land-owner would gain in the following ways:

a) In the early years of implementation, the land-owner would receive a tax-credit against his previous level of sales and income taxes equal to his payment for investment stimulus "fee." (Note that in economic modeling, the newly stimulated economy grows sufficiently, that while major portions of sales and income taxes remain in place, the increased size of the economy provides additional revenues from added sales and income taxes far exceeding the original "stimulus" fees against which the credits were given-which stimulated the added revenue.) Of course the land-owner's tax-offset advantage would disappear after sales and income taxes have been eliminated... as, in a fully employed economy, would most unemployment benefits, and other negative reasons for those taxes to exist.

b) If the land-owner compares the new, uninflated cost of everything he buys[16] through the year to what those costs were before the

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[16] See pages [illegible] and [illegible]8.

"investment stimulus fee," the average home-owner (excepting those who had gained the majority of their annual income from speculation), would find that the "fee" develops an annual savings for the average land-owner well in excess of the sum of the fee and whatever future "unimproved appreciation" that no longer accrues to his property. (It is important to recognize that every dollar gained in "unimproved appreciation" removes a multiple of that amount in unrealized new "capital" otherwise available for investment in plant and product for production and consumption. That "unimproved appreciation" deprives people of jobs and improved living standards by a compound factor of that appreciation.) Have I shown you why "unimproved appreciation" in land and the compound negative effects it creates on the entire economy is matched only by the equally negative redistributive taxes we pay ... both favoring the non-producer/speculator?

c) If the land-owner happens to be a corporation, or is in business, the resultant economy (now devoid of business cycles) would make future planning and investment simpler and more secure. (From persons still believing the "investment stimulus fee" to be comparable to other forms of taxation, about this point I usually expect to hear the comment that the land-owner could be expected to "pass his fee on" to his customer. Fortunately or unfortunately, unlike all other forms of tax, the nature of this unique "fee" stimulates competition among suppliers of all types such that a continual "pass-on" is not possible.

- o The corporate and business/product-oriented land-owners benefit from an ever-larger market for their products in a permanently fully employed economy.
- o The high, stable value of the currency benefits the land-owner in international trade, and in domestically purchased foreign products. Of course a highly valued currency makes travel more appealing (and less expensive).

3. "BUT WHAT WILL HAPPEN TO MY POOR OLD GRANDMOTHER WHO LIVES ON HER PENSION AND/OR SOCIAL SECURITY CHECK? WOULD SHE ABLE TO CONTINUE TO LIVE IN HER OLD HOUSE ON MAIN STREET WHERE SHE HAS LIVED SINCE SHE WAS MARRIED?

That depends. If she is living in an area where "best and highest use" would dictate more rapid development (where she probably would not be very comfortable) she may find the stimulus fee to steep, but she would be able to find better housing suited to her needs (and possibly more to her liking) elsewhere for much less than she would have to pay under the present tax system. If, however, her old country house happens to be in an old country town, or on a dusty country road, it could be that her new fee would total less than her present taxes. In either circumstance, grandmother, like every other taxpayer, will pay less for all her needs, products and services, as either a fee-payer or non-fee payer in a lower cost, higher living standard, stimulated capitalistic society, in contrast to continually inflating costs under a system employing present tax methods. She would no longer need to worry about whether her fixed income pension would see her through, nor about her future financial plans being eroded by inflation. Grandmother would be less subject to the uncertain actions of government that could affect both her land and pension, as is possible under the present tax system and the less successful economy that it engenders.

4. "DOES THE LAND STIMULUS FEE INTERFERE WITH THE 'MARKET THEORY' FOR REAL ESTATE?"

The land tax concept preserves and accelerates all natural market reactions on improved and unimproved real estate. The tax must be implemented in a way that does not distinguish between levels of development within a tax zone. Using the market as the test does however tend to differentiate between passive capitalism (i.e., control speculation) and active capitalism (i.e., investment in productive development).

5. "HARRY HOMEOWNER HAS INVESTED IN A BIG HOME AT HIGH INTEREST RATES TO OFFSET THE COSTS OF INFLATION TO PROVIDE THE FUTURE CAPITAL THROUGH 'UNIMPROVED APPRECIATION' TO PROTECT WIFE WILMA AND HIMSELF FOR THEIR RETIREMENT. WITHOUT THE 'UNIMPROVED APPRECIATION' COULD THEY HANDLE THEIR RETIREMENT UNDER A SYSTEM OF 'INVESTMENT STIMULUS FEES' SUCH AS YOU PROPOSE?"

a) Harry Homeowner should be aware that even when appreciation on his home annually begins to rival his income, present out-of-pocket living costs and economic pressures affecting his future stability, including his job, are increasing by a multiple of every dollar that he now "earns" from that house in "net" unimproved appreciation.

b) I expect he is also concerned over the future of his son Harry, Jr. and daughter Jane. With continuing inflation, where are these young people going to get the money to even hitch their wagon to the "inflation rocket"? ...and if they do, how are they going to make the payments on a house that is going to be an ever greater percentage of their annual earnings? (While all other costs will continue to rise at similar rates.)

c) How about the kind of world Harry, Jr. and Jane will be living in? ... or for that matter, Harry and Wilma as well. With so many people's aspirations frustrated under the system caused by redistributive economics, the general run of people obviously will be harder, more self-seeking, and less concerned over integrity; crime will continue to rise.

d) Wouldn't Harry prefer a life where all of these indices improved every day; in a world where everything he purchased improved in quality and price continually ... like we have heard capitalism is supposed to work? A world where Harry, Jr. and Jane could begin to save for the future and know a maximum cost of their future needs, whether it be for schooling, housing, vacations, retirement, or whatever?

• Footnotes and Definitions

foot note / page

L/1 The "Investment Stimulus Fee" is not the usual tax on Sales&Income. Closer in concept to a "tax on capital" in the tradition of original American tax theory, the "ISF" increases the cost of maintaining real property so as to encourage or "stimulate" owners to improve or sell sub-marginal and non-productive lands and properties. [These sub-marginal properties have negative effects on the course of the entire economy. Without a sufficiently high "stimulus" fee, owners with sufficient resources find that they often can gain a premium, even over a successfully operating plant or property, by holding the property off the market.] The "ISF" stimulates new productive investment, which in turn, results in increased employment, competition, and lower prices - all without spending one cent of the revenues collected! Unlike any other revenue measure, after accomplishing its just described primary function, the revenues collected are then still available to accomplish whatever functions of government remain in a "permanently fully employed economy". The proposal for implementing the "ISF" is one of slowly substituting a small, but annually increasing "fee" for existing income and sales taxes by means of a tax credit arrangement. An interesting aspect of the "ISF" is that while the present requirements of government should continue to decrease due to employing the unique revenue measure, the revenues collected by the government will continue to grow, presenting a new problem of how to democratically and equitably refund those revenues - of course, without defeating the original purpose of the "fee". In a philosophical sense, the purpose of the "ISF" is also diametrically opposed to any other tax. The primary objective of the "ISF" is to create new wealth, and, in the process, expand up to full employment, the opportunities for productive entrepreneurs and those willing to work, to fully participate in a healthy competition for their products and services. It is accepted by any serious statistical economist that such a heightened level of competition by employer for both the services of labor and his place in an ever expanding market, will bring about the greatest cost efficiency, the lowest prices, and the highest level of real personal and business income.

L/2 The "Surplus" referred to here, of course, is the amount of revenues above the projected budget expense for the year. In discussing the "Investment Stimulus Fee" there are several other uses of the word 'surplus'. First, the entire collection of the "fee" is considered a surplus as contrasted with sales&income taxes because the "fee" , in the majority of cases, does not come from consumable income. Even in those instances where it could possibly be considered as consumable income, it is reimbursed via a tax credit, at the start. Once the fee attracts sufficient investment to effect overall competitiveness(which occurs prior to the "fee" resulting in a "net" tax increase to anyone not gaining the largest part of his income as "unimproved appreciation"; the net gain via continually lower prices,(versus cyclic inflation and recession, formerly) and greater personal and business opportunities, will far out-weigh the personal gains of "unimproved appreciation" - and all the consequential disasterous effects on the entire economy. Second, 'surplus'has an important significance in relation to the "fee" because the percentage rate for collection, in concept, must gradually rise to the level required to keep "unimproved appreciation"from occuring, regardless of how far that might eventually exceed the required levels of expenditure for government. The theory holds that revenues gained from what may be termed "re-distributive sources should be declared unconstitutional once the effectiveness of the "ISF" has been proven in practice. A third type of "surplus" is personal time and funds expended voluntarily, for the benefit of individuals, and/or the public at large.(ref:page#3)

1/3 "KNOW WHAT YOU STAND FOR" was the second title given to a draft manuscript for a genuine equitable private enterprise theory developed by Mark Vayda while sitting on his sugar mill equipment business in Cuba during the year following Fidel Castro's arrival to power. The initial effort was made to reach Castro with a ten-page letter on the subject. Later a letter was drafted to President Eisenhauer's National Goals Chairman. The Cuban letter probably never reached proper level and went unacknowledged. the National Goals Commission Letter received only a polite reply. However, in Nicaragua

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on a business consulting assignment in 1966, a chance encounter with Fernando Gordillo, then Nicaragua's most prominent communist leader, substantiated my belief that the equity of the concept would be equally acceptable to the honest intellectuals of both the left and the right. Within six months he became committed to the entire concept. Unfortunately, he died during the next year just prior to my scheduled trip to Nicaragua. I have a strong feeling that things might be somewhat different in Central America today if he were still alive.

2/4 The U.S. Federal Budget has grown from $4 billion in 1931 to $668 billion in 1981. This growth-rate is surpassed by only one statistic in the same fifty-year time span: The increase in land and property values in conditions of close "Control Appreciation", which in many instances, have "appreciated" by two and three times as much as the stupifying growth-rate of government, (i.e., 20-30,000%)

3/5 "Maximum Discomfort Level" (could just as easily have been called 'Optimum Comfort Level') is defined as that financial and mental state reached at some point by an owner of land, or a plant or factory. It applies to the original entrepreneur himself in his more settled years, or to his heirs who do not add a personal dimension to the growth of the product through improvement in efficiency of the product itself or the economy of bringing it to the market place. It reaches its visible manifestation when the income, yield, and prospects for yield, exceed the owner's aspirations (versus the level of investment or effort he is able or willing to dedicate toward improving the efficiency and profitability of his "productive" investment). When that point is reached within the classic "land-inflationary" economy, generally there is no incentive to sell, because "unimproved appreciation" will take over and increase the value of everything from the land to the plant to the value of his end product. Within such an economy, the final sell-out for "unimproved", or in this instance "control" "appreciation", will reward the owner with a higher yield than any form of financial instrument he could buy (despite the higher interest rates prevalent in those inflationary economies) or, when the condition becomes sufficiently extreme, higher than he could achieve even by continuing on with the headaches as the productive entrepreneur. Of course, the "ISF" stimulates the owner to bring about progress, whether or not the plant is located on land belonging to the plant owner.

4/4 "... leaving the poor in greater poverty than before." The essence of this statement is that the inflation caused by "unimproved appreciation" and "re-distributive taxation both favor the person with the existing wealth, increasing the relative spread between the rich and the poor; and(while the re-distributive process can, with the presence of special circumstances, give a "quick fix" to the economy and/or the have-nots) the long run effects on both have to be negative, as I hope we amply explain within the context of this entire discussion.

4/6 "...and those ' conservatives', supposed targets of the re-distribution, become primary beneficiaries by having their major "unimproved" or "sub-marginal" assets increase in value at a rate far exceeding the taxes imposed, or the effects of inflation on their costs." The entire discourse will make this point apparent, however reference to footnotes 3/5 & 4/4 above, plus the definition of unimproved appreciation on page 15 will provide a quick concept introduction to the point.

4/7 "underdeveloped capital", "investment", and/or"real estate" all imply the same: The investment is not being utilized at a level to compete in a genuinely competitive market place. Furthermore, it generally follows that "income-from-operations" is not the primary cause for ownership... yet, as explained under "unimproved and/or control appreciation" the eventual profit from maintaining the "status quo" will probably be greater in the long run in a "land inflationary" economy, than if the owner had chosen the more aggressive and risky course of the "productive entrepreneur."

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4/8 "What is harmful, is that an ever increasing percentage of captialists are being attracted to so-called "conservative investments", the holding of which act to restrain productive investment. This process I call "Control Appreciation or "Control Speculation" which will gain increasingly higher yields in comparison with productive capitalism (with periodic recessionary blips) for as long as the system is able to survive. "Control: Appreciation/Speculation/Investment", as the word "control" implies, is simply a major and often the initiating force in the process of "unimproved appreciation" defined on page 15. For a good understanding of "Control Appreciation" see pages 9-12, also 86.

4/9 "Business Cycles" It is generally accepted that business cycles are due to "an absence of perfect competition". I shall not enter into a debate on the feasibilty of perfect competition, I will say that "ISF" will bring us closer to perfect competition than has ever before been experienced. Furthermore, "business-cycles", to the extent that they impinge on broad sectors of human life can be diminished to inconsequential without reaching "perfect competition" when the "ISF" is employed per formula ... and ... no improper labor factors are introduced into the economy, (see footnote 10/18)

5/10 "Motor Power is the earned income on which an individual and a nation depend for their very survival: sustenance, and improvement of same; i.e., investment in new house, plant, production, product, and the like. When exchanges of old and existing properties occur at inflated figures, without added improvement, the whole economy, and, in certain conditions, the entire world is the loser, and suffers the inflationary consequences.

6/11 "Unimproved Appreciation" (technically defined at the bottom of page 15), generally stated, is the amount of appreciation that accrues to a property beyond the capitalization of carrying costs of closest raw land, and improvements, or improvement of income - whichever is greater. (also see 4/6; 4/7:8/6, 11/19; &11/20 ... pages 26-30).

7/1; 7/12 " ... applicable to any so-called "free-world nation. To the degree that the basic rights of life, property, and the pursuit of individual happiness have been abridged the "ISF" stimulus will, of course be rendered ineffective. The countries of United States, El Salvador, and Zimbabwe were singled-out for mention because the elected officials of each country were subjected to a very competitive, and, we are led to believe, highly ethical electoral process. Officials so elected feel a greater sense of responsibility to properly represent the interests of all the citizenry than officials arriving at or keeping office by any other means. In addition, each of these countries presently faces crisis level economic problems, with major political ramifications, which could be so equitably and simply resolved by use of the "ISF" stimulus. In each case, the time for implementation is now! If this only equitable solution is not implemented with all haste, the crisis level problems of each country can only grow worse in the long term ... and probaly in the short run as well.

7/13 For a list of advantages for the "ISF" beyond those listed on page 7, refer to pages 19-20.

8/14 "The Poorer the Country, the Higher the Price of Land" ... And the lower the percentage of government revenues that come from the land. In case it was not already clear, I have added the second half of this axiom to confirm the direct relationship between the price of land and the tax incentive to "milk it or move it", as the old farmer used to say.

8/15 "a high land price is a major deterrent to development in developed and under-developed countries alike." Strangely, in all countries, pecular rationales are given justifying and, in many cases implying that the high land price has some beneficial effect to it. Of course there are other deterrents to development, but implementing the "fee" will cause the others to 'fall into place' and become less important, non-existent, or more easily memidied.

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8/6 "Control Appreciation" is the same as "unimproved appreciation" except that
it has as the word'control'implies, a major effect on the market place, and thus
acts as a greater deterrent to economical development. For further information
see footnote 4/8 and pages 9-12+15 of this discourse. (also see 4/6)

9/16 Heirs of George Washington versus decendants of Spanish General deVelasco.
While many Americans claim blood relationship to those of wealth and importance
in early revolutionary United States, there are no obvious chains of great wealth
dating back two hundred years in the United States. There are no great dynasties
of wealth dating back that far like there are in other countries. In fact, try
if you will to find another country that does not have a more visible continuity
of wealth dating back two hundred years or more. However, since the trend away
from land based tax to redistributive taxation, our economic problems and establishment of financial dynasties have grown in direct proportion to the reversal of
our traditional tax base as we have come to recognize and give something akin to
monarchical and class-type deference to "old" wealth (when in most cases the last
creative, productive enterprise was undertaken by their grandfathers). But who is
taking time to analyze that such wealth, if invested(as we defined)'conservatively',
is really acting against a non-inflationary, effective economy(in which everybody's
share of ever lower priced, higher quality and more available product would continually improve?)
It is also interesting to note that recent immigrants, accustomed to operating
in an atmosphere devoid of land and property taxes, have been the leaders in
bilking our financial institutions, very rapidly establishing themselves as
"landed gentry" in their newly adopted (or temporary) country - without contributing
one Iota of productive entrepreneurial activity to their new homeland.

9/17 "Land taxes were inconsequential in Cuba." In the years just prior to the Cuban
revolution, the real estate "appreciation"accelerated at levels not experienced
in the United States prior to the last ten years. As soon as a person joined the
work force, his first thoughts were devoted to how he would amass the down payment
for a lot ... i.e., his entry into the established society. The premium that they
paid for that entry into the active economy was punitive. For most of them they
expected a ten-year period before they could consider any other major expense. How-
ever, as you would assume, the parcels from estates of the deVelascos and other
important land-owners continued to "appreciate"in value, providing my young Cuban
friends with a handsome profit whenever they decided to trade-out of the land
ownership position. It should be recognized that precious little of this activity
contributed to the production of real goods and services of consumable value to
these young people, or to improving the standard of living of these aggressive,
bright young people. It did, however prepare them well for maximizing their gain
on our continually degenerating system in the U.S. as they arrived here as independent-
minded political refugees.(Refugees from other countries I could mention are infinitely
better prepared to maximize their gain from the degenerating system existent in the
U.S. today.)

10/18 "actions by others" falls in several categories: The 1st refers to the actions of
government officials over whom the "control speculator" may be inclined to exercise
undue influence because of the major effect such actions can have on his rate of
"unimproved appreciation". A 2nd refers to anyone whose actions increase the rate
of inflation. These would include: increases in government spending, improvements
in wages without more than off-setting increases in cost, and eventual selling price
of the product involved. A 3rd would be productive actions on the part of owners
of adjoining and/or nearby properties. Fourth would be (as is presently happening)
changes in the tax code providing preferential tax treatment to those involved in
control and unimproved appreciation. Of course such legislation can only draw increas-
investor interest to that sector, providing existing control-speculators with an
additional windfall. Government influenced high interest rates, which also artific-

raise the cost of doing productive business, tend to concentrate "savings" in a holding pattern awaiting the next great opportunity. As industrial failures increase during this period, the largest of the control speculators may not even take advantage of the general move toward money market instruments, knowing that eventually the interest rates must come down, and that they will reap a greater "unimproved appreciation" than ever through keeping and adding to their stock of "underdeveloped investments"

11/19 "Productive Capitalism vs Control Speculation". A major thrust of this discourse has been to make abundantly clear, the differences between these terms and the concepts associated with them. We define "productive capitalism" simply as an entrepreneurial activity which results in the creation of a new or improved product or service. A more price competitive product would also conform to this definition. In contrast "control speculation" we define as gaining control of an existing entity, on which future value will increase due to the action of others without any productive investment of time or money on the part of the investor-controller. The net effect of such action is the restraining of current productive investment, for which the "control speculator"receives ever higher rewards in a "land inflationary" oriented economy (which expression is fully operative for us in the United States - 1982). It even forces doctors, and other professionals to become "control capitalists" often devoting more of their mental anguish, if not total energies, toward protecting their present gross income through "unimproved appreciation" with that eventual source of yield quickly exceeding what they are making from their profession. Result: less dedicated and more harried physicians, ever more cynical about the entire economic process. They profess entrepreneurial capitalism out of an interest in retaining what is basically their"s (from taxes) but are ensnared in a negative activity that can only end up taking more qualified men away from the profession, and cause our medical costs to continue to soar.

11/20 "Control Speculation ", of course can apply to any underdeveloped property, however, if an adequate stimulus exists on the underlying land, it becomes impossible for a single entity to maintain control over a specific regional market, or industry. What we are saying is that an appropriate "land stimulus fee", in and of itself, will bring into play increased competition in all parts of the market place.

13/14 "... and even you may be forced to desert your field...". Productive enterprise in the United States has already been reduced to the point that only thirty(30%) percent of the work force is now engaged in productive labor and the US. runs a continual negative balance of trade.. Neither economically nor militarily can a country sense any feeling of security under these conditions.

15/21 Obviously, the "Investment Stimulus Fee" is not a version of the discriminatory "idle lands tax. Apart from the lack of equity of such programs, they are more complicated to implement and enforce, and have proven unworkable.

16/22 "The "ISF" induced grand total of new revenues would equal a minimun of $125 billion." Even using sound concepts, predicting economic behavior in precise terms, at the very best, either must list all possible interferences, or risk a major possibility of inaccuracy. The major possible interferences include any factor ranging from continued loose immigration policy, to additional wage increases not resulting from either increased productivity, or increased competition for the services of labor in the market place, to further government interference in the process of determining the supply of money.